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Executive summary
Living standards are rising steadily

Thanks to a steady economic expansion and helpful government policies, poverty rates and inequality are falling, and access to public services is broadening. Income per capita growth is strong. Yet, the infrastructure gap remains large, and more spending on health and social assistance is needed to enhance inclusiveness. Well-being would also benefit from greater attention to environmental outcomes.

Economic growth has been solid at around 5% per year since 2013, driven by consumption but also, more recently, by much-needed infrastructure investment (Figure A). The recovery in global trade has boosted exports. The import bill has also risen due to higher oil prices and capital goods purchases, contributing to the current account deficit. Annual inflation is well within the target band of 3.5% +/-1%.

Figures A. Economic growth is solid

Source: CEIC.
StatLink  https://doi.org/10.1787/888933832685

Macroeconomic policies are finely balancing growth and stability. After lowering policy interest rates during 2016-17 to support economic growth, Bank Indonesia has started to raise them to temper capital outflows. The budget deficit is expected to narrow in 2018 and 2019, expanding the buffer vis-à-vis the legislated cap of 3% of GDP.

GDP growth is projected to remain healthy (Table A). Rising incomes and consumer confidence will support a pick-up in private consumption. Investment is projected to remain robust. Improvements in logistics and price competitiveness will support export growth even as trading partner growth slows.

<table>
<thead>
<tr>
<th>Table A. Growth is projected to remain healthy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage change unless indicated</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>2017</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>Gross domestic product</td>
</tr>
<tr>
<td>Private consumption</td>
</tr>
<tr>
<td>Government consumption</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
</tr>
<tr>
<td>Exports</td>
</tr>
<tr>
<td>Imports</td>
</tr>
<tr>
<td>Consumer price index</td>
</tr>
<tr>
<td>Fiscal balance (% of GDP)</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
</tr>
</tbody>
</table>

Source: OECD Interim Economic Outlook, September 2018.

A key downside risk to the outlook stems from capital outflows related to US monetary tightening. Large outflows would require a steeper path for interest rates, slowing growth. On the upside, past regulatory reforms and the expansion of infrastructure could boost investment and exports faster than expected.

Government debt is low and sustainable

The deficit rule is containing the growth of debt. But additional spending on infrastructure, health and social assistance is limited by low revenues. Accordingly, resources must be found through greater efficiency and higher revenues. Growth in the public wage bill was curbed in 2017, and targeting of sub-national transfers is improving. However, spending on energy subsidies has risen anew after falling over 2014-17. Shifting social assistance more towards conditional cash and non-cash transfers would improve targeting.

State-owned enterprises are contributing to the development agenda through infrastructure investment, loans to small businesses and price restraint. Yet, growing financial vulnerabilities might in time require public capital injections. SOEs’ dominance in some sectors crowds out private capital. Governance would benefit from increased disclosure, strengthened procedures for board appointments and more explicit mandates with adequate independence to pursue them. Implicit fiscal risks from SOE losses and rising debt at some require more attention.
Tax revenues are low relative to other emerging economies (Figure B). Registration has expanded but compliance remains a major challenge.

**Figure B. Tax revenues are low**

![Graph showing tax revenues as a percentage of GDP for various countries, including IDN, MYS, PHL, MEX, COL, TUR, ZAF, and BRA.](source: OECD, Revenue Statistics Database, StatLink [https://doi.org/10.1787/888933832704](https://doi.org/10.1787/888933832704))

**Strengthening the tax administration is a government priority** and is crucial for improving compliance. Modernising IT systems and processes can promote compliance and improve enforcement. But it will increase demands for highly skilled staff who are in short supply. Effectively using the swathes of new data is crucial to deter future evasion and could help boost revenues. Complexity and frequent policy changes make compliance more difficult. Wider public consultation ahead of proposed changes to tax legislation would enhance the quality of legislation over time.

**Low incomes and widespread informality imply that the personal income tax net currently includes few individuals and raises scant revenue.** The initial income threshold for paying income tax is relatively high. At medium- to high incomes, marginal tax rates are well below those in other emerging economies. Gradually lowering the top income tax thresholds would make the system more progressive and raise additional revenue. High-income earners disproportionately benefit from the tax-free treatment of fringe benefits within personal income tax.

**The corporate income tax base is also reduced by informality and the prevalence of small firms.** Tax holidays and other incentives target specific sectors and locations and have been expanded recently to attract new investment. However, these risk eroding the tax base, creating distortions and spurring further regional tax competition. The recent publication of revenue forgone due to tax incentives improves transparency. These estimates should be published annually, as planned. Shifting to cost-based tax incentives would sharpen investment incentives. Competitiveness concerns could be addressed through greater regional co-operation.

**Value-added tax generates sizeable revenue** but its revenue-raising potential is undermined by exemptions, including for hotels and restaurants, which are subject to local sales tax, and some intermediate inputs. A high threshold for compulsory registration for firms weakens the self-enforcement mechanism embodied in the tax. A reform package removing most exemptions, replacing local sales tax by VAT, compensating local governments for lost sales tax revenue, and lowering the registration threshold would raise compliance. An accommodation tax for local governments would incentivise them to develop tourism.

**There is scope to better use taxes for health and environmental aims.** Smoking rates are high and tobacco taxes are lower than elsewhere. Motor vehicle taxes can be better linked to environmental effects. Phasing out fuel subsidies would be a first step towards more cost-reflective energy pricing.

**Recurrent taxes on land and structures raise relatively little revenue.** The first step is to ensure local governments are able to maintain and update their property tax databases. Then the cap on rates should be raised.

**The youthful population is an opportunity**

Half of Indonesia’s population is under 30 years old. This favourable age structure will contribute to future prosperity, if policies are put in place to take advantage of it. Reaping the benefits of this opportunity requires shifting the jobs mix to high-quality, high-productivity formal-sector jobs. Improving the health of students and workers will raise learning and productivity.

**Around half of all dependent employees and 70% of all workers are estimated to still be informal** (Figure C). These jobs tend to be...
associated with lower wages, poorer working conditions and fewer training opportunities. Disadvantaged groups are more likely to be affected, particularly those with less education.

**Figure C. Informality has fallen but is still high**

![Informality has fallen but is still high](image)

*Source: Statistics Indonesia; OECD calculations.*

**StatLink**  
[https://doi.org/10.1787/888933832723](https://doi.org/10.1787/888933832723)

Stringent employment regulations, including high dismissal costs and minimum wages, curtail formal-sector employment. Easier employment regulations and a discounted minimum wage for youth could be trialled in special economic zones and, if successful, extended across the country. Improving business regulation at all levels of government would lower the barriers to formalisation. Linking the turnover tax to additional benefits such as access to business development services and book-keeping applications could encourage formalisation and increase revenue. To contain costs, eligibility for the tax should be restricted to very small firms.

Educational attainment has increased, but a scarcity of skills is holding back growth and incomes. The quality of education is still a concern. Teachers should be evaluated regularly and encouraged to undertake professional development by linking remuneration to performance. The government is focusing on developing skills by improving vocational schools. Strong employer engagement and national co-ordination are crucial for success.

Relatively little use is currently made of foreign workers to fill skill shortages. These workers could help to quickly fill acute skills shortages in high-skill jobs, boosting growth, supporting foreign investment and facilitating knowledge transfer. A list of highly skilled occupations with severe shortages could be created, for which processes could be simplified and expedited.

**Tourism can boost regional development**

Growth in tourism has been remarkable. Annual visits have almost tripled over the past decade, with China becoming the largest source (Figure D). The government aims to reach 20 million foreign tourists by 2019. To unleash the full benefits for regional populations, vocational and on-the-job training should be expanded, driven by local needs. Infrastructure rollout is encouraging tourism, but gaps remain including in tourism-specific infrastructure and environmentally related infrastructure.

**Figure D. Tourist arrivals have surged**

![Tourist arrivals have surged](image)

*Source: CEIC; UNWTO.*

**StatLink**  
[https://doi.org/10.1787/888933832742](https://doi.org/10.1787/888933832742)

The central government is driving the tourism strategy, which helps prioritisation. However, local governments are not sufficiently involved. Greater co-ordination would ensure that tourism serves regional development needs. Targets should focus less on tourist numbers and more on revenue generated.

Tourism can create economic incentives to protect natural resources. Protected areas should be expanded and more open to visitors. User fees, along with quantitative restrictions as necessary, could control visitor numbers and help fund the maintenance of these sites.

Land clearing and peatland fires continue to generate environmental, health and economic costs. Moreover, air pollution from transportation is rising. Clearer land rights and better law enforcement would help control deforestation. Taxes, together with road pricing, could help curtail vehicle use.
### EXECUTIVE SUMMARY

**MAIN FINDINGS**

<table>
<thead>
<tr>
<th>Making the economy more resilient and inclusive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth is projected to remain healthy but there is a risk of continued capital outflows. Monetary policy and fiscal policy are successfully balancing growth and stability, and the fiscal stance is broadly neutral. Reform of energy subsidies has stalled.</td>
</tr>
<tr>
<td>State-owned enterprises contribute to development but rising leverage, increasing cost pressures and losses at some firms represent fiscal risks. In some sectors they crowd out private investors.</td>
</tr>
<tr>
<td>Low-quality, informal jobs remain prevalent and there are many informal micro enterprises. Stringent employment regulation, high severance costs and high minimum wages discourage formal employment of low-skilled workers. Business regulations have been streamlined but are still burdensome at all levels of government.</td>
</tr>
<tr>
<td>Educational attainment is rising but still low. The quality of education remains a concern. Skills shortages are constraining growth. Better targeted government social assistance is expected to reduce student drop-out rates.</td>
</tr>
</tbody>
</table>

**KEY RECOMMENDATIONS**

<table>
<thead>
<tr>
<th>Making the economy more resilient and inclusive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deepen domestic financial markets to mitigate risks of capital outflows. Continue to act pre-emptively, including by raising interest rates as needed, to maintain price and financial stability. Improve targeting of social assistance, including by shifting towards more conditional transfers.</td>
</tr>
<tr>
<td>Improve the transparency and governance of state-owned enterprises, including by strengthening their supervision and selection of board members. Give public enterprises clearer mandates with greater independence to achieve these.</td>
</tr>
<tr>
<td>Pilot lower levels of employment protection and discounted minimum wages for youth in special economic zones. If successful, extend them. Further simplify business regulations to encourage formalisation and collect user feedback to improve the online single submission system.</td>
</tr>
<tr>
<td>Introduce regular teacher evaluations and link teacher remuneration more closely to performance and ongoing training. Encourage greater employer engagement in vocational education and training. Create a list of highly skilled occupations with acute skills shortages, and ease restrictions on hiring foreign workers in these areas.</td>
</tr>
</tbody>
</table>

### Raising more revenues to meet spending needs

| Tax revenues remain low, constraining public spending on infrastructure, education, health and social protection. Registration has increased, but improving compliance remains a challenge. Planned technology upgrades at the tax administration will raise demand for highly skilled civil servants. Complex regulations and frequent policy changes add to compliance costs. |
| A high basic tax allowance for personal income tax reduces the number of taxpayers. Higher rates are not applied until high levels of income. Different types of income are treated differently. |
| Numerous exemptions and a high threshold for compulsory registration reduce the efficiency and effectiveness of the VAT. Sectors such as hotels, restaurants and entertainment are instead subject to sales tax at the sub-national level. |
| Taxes are used less than in other countries to target health and environmental outcomes. Smoking rates for men are amongst the highest in the world. |
| Recurrent taxation of immovable property raises relatively little revenue partly because of a cap set by the national government. Some district registers are out of date and many districts lack capacity to administer property taxes. |

**KEY RECOMMENDATIONS**

<table>
<thead>
<tr>
<th>Raising more revenues to meet spending needs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase investment in tax administration, particularly staff, electronic services and databases. Make greater use of information technology to strengthen monitoring and facilitate tax compliance. Continue to expand and improve tax expenditure estimates and publish them annually, as planned.</td>
</tr>
<tr>
<td>Freeze the basic tax allowance for individuals to broaden the tax base. Gradually lower thresholds for paying the top two rates of personal income tax. Include fringe benefits and employer allowances in taxable income.</td>
</tr>
<tr>
<td>Broaden value-added tax by removing most exemptions, especially for intermediate goods, replacing local sales tax with VAT, and lowering the threshold for compulsory registration. Compensate sub-national governments for lost sales tax revenue and allow them to charge a tax on accommodation nights. Increase and harmonise tobacco excise across products.</td>
</tr>
<tr>
<td>Increase training and assistance for sub-national governments to improve the quality of property tax databases, valuation methods and tax administration. Raise the cap on property tax rates.</td>
</tr>
</tbody>
</table>

### Developing a stronger and sustainable tourism sector

| The central government is driving the tourism strategy. This helps prioritise planning and co-ordination, but local governments are not sufficiently involved. Local infrastructure is still lacking, including environmental infrastructure and tourism-specific services such as information centres. |
| Tourism is labour intensive and growing rapidly and skills shortages are increasing. |
| Government medium-term objectives are mostly based on the number of tourists, which risks generating unsustainable inflows. |
| Natural assets are plentiful. The share of protected areas is low by international standards, and they are generally closed to the public to preserve highly sensitive zones. |

**KEY RECOMMENDATIONS**

<table>
<thead>
<tr>
<th>Developing a stronger and sustainable tourism sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incorporate needed infrastructure in forthcoming destination management plans to ensure sustainable development of tourism. Expand vocational and on-the-job training to build tourism-related skills in the workforce, especially in areas with skills shortages.</td>
</tr>
<tr>
<td>Give more prominence to revenue-based targets for tourism in future plans. Increase the coverage of protected areas, and consider opening more for tourism use, but with visitor controls including regulations, and appropriate user and concession fees.</td>
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</table>
Key Policy Insights

Income gains and government policies are lifting well-being

Indonesia is Southeast Asia’s largest economy, rich in all types of natural resources as well as cultural diversity. A young and dynamic democracy, it is urbanising and modernising rapidly. In contrast with most OECD countries and many emerging economies, around half of the population is under 30 years old, and the working-age population ratio is set to rise during the next decade (United Nations, 2017).

Two decades after the 1998 Asian Financial Crisis, and one decade after the Global Financial Crisis, Indonesians’ living standards are far higher than before, and their economy is more resilient. GDP per capita has risen by 70% during the past two decades (Figure 1). The end of the commodity price boom weighed on incomes and government revenues, yet GDP growth has remained around 5%, and per capita income has increased by almost 4% annually. Poverty rates have fallen in both rural and urban areas (Figure 2, Panel A). Distribution has also improved of late: the Gini coefficient on consumption has been declining since 2015. Confidence in the national government is higher than in any OECD country (Panel B). Prudent macroeconomic policies and progress in structural reforms have been recognised by credit rating agencies, and Indonesia has climbed up international rankings of competitiveness and the business environment. Since 2015 Indonesia has leapt 34 places in the World Bank’s *Ease of Doing Business* ranking to 72nd.

![Figure 1. Incomes have grown rapidly in the past decade](https://doi.org/10.1787/888933832761)

Nonetheless, policy makers are faced with numerous challenges as Indonesia progresses towards higher-income status. Many of the poor are trapped in precarious employment relative to other emerging economies, particularly women (Figure 3). Regional disparities in income and well-being are also huge (OECD, 2016a). Infrastructure needs are large – equivalent to 7% of GDP each year according to the government’s medium-term plan for
And there is more work to do to streamline regulations, increase regulatory certainty and fight corruption. Health spending is low relative to GDP, and the social safety net is still in its infancy. There are also risks that growth endangers environmental sustainability. The main messages of this Survey are:

- Shifting the job mix to high-quality, high-productivity positions in the formal sector will boost living standards and share the demographic dividend with future generations. Doing so will require tackling pervasive informality and skills deficiencies.
- Low tax revenues constrain government spending on infrastructure and social services. The key to durably raising revenue is to improve compliance and broaden tax bases.
- Tourism has the potential to diversify the economy, boost regional development and reduce inequalities. Tourist numbers are soaring but measures are needed to make this rapid growth consistent with long-run environmental sustainability.

**Figure 2. Poverty is improving and trust in the national government is high**

- **A. Poverty rate**
- **B. Confidence in national government, 2017**

*Note:* The poverty rate is the percentage of the population below the poverty line, which is based on the minimum expenditure for food equivalent to 2 100 kilocalories per day, and basic housing, clothing, education and health needs.

*Source:* Statistics Indonesia; Gallup World Poll.

[StatLink](https://doi.org/10.1787/888933832780)
The economy is expanding at a healthy pace

GDP growth has remained around 5% since 2013. Supportive macroeconomic policies, greater confidence and stronger external demand boosted activity in 2017, with momentum continuing into 2018. Consumption continues to underpin spending (Figure 4, Panel A). Consumer confidence is relatively high, and unemployment has declined, supporting income gains. Infrastructure investment increased strongly, though from low levels, and capital goods imports have soared (Panel B). The increase in commodity prices, notably for mineral products, is supporting mining activity (Panel C). The overall business environment is friendlier, thanks to ongoing regulatory reforms. However, frequent regulatory changes add to uncertainty.

Exports are growing again, and broadly in line with growth in export markets (Figure 5, Panel A). Commodities account for 40% of total exports, down from around half at the peak of the commodity price boom (Panel C). Services, mostly tourism, and manufactures have grown in importance. The recent surge in investment-related imports, along with higher oil prices, has eroded the trade surplus of 2017 (Panel B). The primary income deficit was 3.2% of GDP in 2017. This deficit is likely to continue due to Indonesia’s success in attracting foreign investment, although rising interest rates abroad will add to income. Overall, these developments led to the widening of the current account deficit to 2.6% of GDP in the first half of 2018.

In the first half of 2018 capital outflows associated with US monetary policy normalisation caused tighter financial conditions in Indonesia and other emerging economies (Figure 6). Indonesia’s bond prices are particularly exposed to capital outflows because of foreign-currency risk and high foreign ownership: at March 2018 international debt securities in foreign currencies amounted to 19% of GDP, and almost 40% of local-currency government bonds were foreign-owned. In May Bank Indonesia began raising key interest rates to stem capital outflows. It followed this with further increases in June, August and
September. It has tried to partly offset the effect on financial conditions by injecting additional liquidity in domestic money markets and raising loan-to-valuation ratios for property lending.

**Figure 4. The economy continues growing solidly**

Inflation eased to 3.1% in the third quarter of 2018, well within the official target range of 3.5% +/- 1% (Figure 7). Core inflation is subdued. Food price inflation picked up in early 2018, partly driven by some temporary shortages. The prices of some products, such as rice, are capped, and the government has decided to freeze administered energy prices for 2018-19. These measures aim to limit the pass-through of cost increases to consumers but have knock-on effects on producers and increase the budgetary cost of energy subsidies.

GDP growth is projected to reach 5.3% in 2019 (Table 1). Even with pass-through from currency depreciation, inflation is likely to remain within the target range. Income gains and low inflation will boost private consumption. Investment growth will hold up ahead of the 2019 elections, which may also induce higher government spending. Improved logistics and price competitiveness will support export growth even as trading-partner economies slow somewhat.

StatLink  
[https://doi.org/10.1787/888933832818](https://doi.org/10.1787/888933832818)
Figure 5. Exports are growing again

A. Export volumes

- Export markets
- Exports
- Export performance

B. Current account balance

- Trade balance (goods and services)
- Current account balance

C. Exports of goods and services

- Other goods
- Services
- Oils, fats and waxes
- Food
- Chemicals
- Crude materials, inedible, except fuels
- Machinery and transport
- Mineral fuels
- Other manufactured goods

D. Export destinations

- China
- Japan
- USA
- India
- Singapore
- Other Asia
- Europe
- Other

Note: Data shown in Panels A and B are seasonally but not working-day adjusted. Export market is the import volume of trading partners weighted by export shares. Export performance is the ratio between actual exports and export market. Panels C and D are for 2017. Export destination data are available only for goods.

Source: OECD, OECD Economic Outlook 103 Database; CEIC; United Nations, Comtrade Database.

StatLink: https://doi.org/10.1787/88893832837

Figure 6. Financial markets moved sharply during 2018

- US dollar exchange rate (left scale)
- Equity prices (left scale)
- Bond spreads to US Treasuries (right scale)

Note: Equity prices are the MSCI Index for each country. Bond spreads are the JPM EMBI+ Bond Index stripped spread (to US Treasuries) for dollar-denominated bonds.

Source: Thomson Reuters.

StatLink: https://doi.org/10.1787/88893832856
Figure 7. Inflation has eased to low levels

A. Headline and core inflation

B. Administered and volatile food price inflation

Note: CPI is the Consumer Price Index. Core inflation excludes administered and volatile food prices. Administered prices include those for cigarettes, electricity, water, some modes of transport and certain fuels. Source: CEIC; Thomson Reuters.

StatLink 2 \[\text{https://doi.org/10.1787/888933832875}\]

Table 1. Macroeconomic indicators and projections

<table>
<thead>
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<th></th>
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<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross domestic product (GDP)</strong></td>
<td>4.9</td>
<td>5.0</td>
<td>5.1</td>
<td>5.2</td>
<td>5.3</td>
</tr>
<tr>
<td>Private consumption</td>
<td>4.8</td>
<td>5.0</td>
<td>5.0</td>
<td>5.2</td>
<td>5.4</td>
</tr>
<tr>
<td>Government consumption</td>
<td>5.3</td>
<td>-0.1</td>
<td>2.1</td>
<td>4.7</td>
<td>3.6</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>5.0</td>
<td>4.5</td>
<td>6.2</td>
<td>6.5</td>
<td>5.9</td>
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<tr>
<td>Stock building(^1)</td>
<td>-0.8</td>
<td>0.6</td>
<td>-0.2</td>
<td>0.7</td>
<td>0.0</td>
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<tr>
<td>Total domestic demand</td>
<td>4.0</td>
<td>5.0</td>
<td>4.8</td>
<td>6.1</td>
<td>5.3</td>
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<tr>
<td>Exports of goods and services</td>
<td>-2.1</td>
<td>-1.6</td>
<td>9.1</td>
<td>5.5</td>
<td>5.6</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>-6.2</td>
<td>-2.4</td>
<td>8.1</td>
<td>10.3</td>
<td>5.7</td>
</tr>
<tr>
<td>Net exports(^2)</td>
<td>0.9</td>
<td>0.2</td>
<td>0.3</td>
<td>-0.8</td>
<td>0.1</td>
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</table>

Other indicators

<table>
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<tr>
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<th>2015</th>
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<th>2018</th>
<th>2019</th>
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</thead>
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<tr>
<td>GDP deflator</td>
<td>4.0</td>
<td>2.5</td>
<td>4.2</td>
<td>3.6</td>
<td>4.1</td>
</tr>
<tr>
<td>Consumer price index</td>
<td>6.4</td>
<td>3.5</td>
<td>3.8</td>
<td>3.5</td>
<td>3.9</td>
</tr>
<tr>
<td>Trade balance(^3)</td>
<td>0.4</td>
<td>0.8</td>
<td>1.2</td>
<td>-0.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>Current account balance(^2)</td>
<td>-2.0</td>
<td>-1.8</td>
<td>-1.7</td>
<td>-2.5</td>
<td>-2.5</td>
</tr>
<tr>
<td>Government fiscal balance(^2)</td>
<td>-2.8</td>
<td>-2.4</td>
<td>-2.5</td>
<td>-2.2</td>
<td>-2.0</td>
</tr>
<tr>
<td>Three-month money market rate(^4)</td>
<td>8.3</td>
<td>7.2</td>
<td>6.5</td>
<td>6.1</td>
<td>6.8</td>
</tr>
<tr>
<td>Ten-year government bond yield, average(^4)</td>
<td>8.2</td>
<td>7.6</td>
<td>7.0</td>
<td>7.5</td>
<td>8.6</td>
</tr>
</tbody>
</table>

1. Contribution to changes in real GDP.
2. As a percentage of GDP.
3. National accounts basis, which can differ from official estimates on a balance-of-payments basis.
4. In per cent.
Source: OECD, OECD Economic Outlook Database, OECD Interim Economic Outlook, September 2018.

A key downside risk to the projections is that stemming capital outflows might require a steeper path for interest rates, slowing growth. Rising trade protectionism is a risk to exports, especially if it targets Indonesian exports directly or dents Chinese demand for...
Indonesian exports. On the upside, reforms to reduce red tape together with the completion of large infrastructure investments could provide a larger boost to private investment and exports than projected. Further increases in relevant commodity prices would raise nominal export growth and government revenues more than projected. Since Indonesia is a large oil producer but also a net importer, an oil price spike would widen the current account deficit and heighten cost pressures.

External debt is low relative to the past and to other countries (Figure 8, Panels A, C and D). But foreign-currency-denominated debts are higher (Panel B). Together with current account and budget deficits, this means that major disruptions in financial markets could have a large impact, especially if accompanied by falling commodity prices, which would reduce foreign-currency earnings (Table 2). An unexpectedly sharp slowdown in China would also be costly, as could a natural disaster. However, compared to other countries the overall level of government and private debt are low and the banking sector is highly capitalised (Panels E to H).

Policy makers have taken steps to reduce external vulnerabilities, particularly after the current account deficit widened during the second quarter of 2018. Official reserves stood at USD 118 billion in August 2018 – equivalent to 6.6 months of imports and debt servicing. To maintain sufficient funds to provide insurance against a crisis, their use should be limited to containing volatility in the interim. Since 2015 hedging and liquidity requirements have been phased in for borrowers with foreign-currency debt: 25% of net foreign-currency liabilities falling due within each of the next two quarters must be hedged with a domestic bank. Around 90% of corporates have complied, but risks remain (Republic of Indonesia, 2018). Agreements with neighbouring countries to settle payments bilaterally in local currencies rather than US dollars reduce demand for dollars. In August, the “IndONIA”, a new overnight benchmark interest rate, was launched to facilitate the development of derivatives products by providing a reliable reference rate. Additional measures are planned. Further developing financial markets would lower the cost of hedging and facilitate rupiah-denominated debt issuance, increasing resilience against exchange-rate swings.

The authorities have also enacted measures to try and narrow the current account deficit. These have included: expanding the supply of biodiesel containing palm oil to reduce fuel imports; increasing withholding tax rates on 1 147 imports, most of which are consumer goods (these taxes are treated as tax credits against corporate income tax liabilities); and postponing selected infrastructure projects with high import content that had not yet begun. There is a risk that restrictions on trade lead to adverse effects on growth. The depreciation of the exchange rate should help reduce demand for imports, while making exports more attractive. Continuing with earlier reforms to streamline export procedures and lower related costs would also help to reduce the current account deficit, as well as support growth.

<table>
<thead>
<tr>
<th>Vulnerability</th>
<th>Possible outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disruptions to financial markets as major economies normalise monetary policy</td>
<td>The economy would slow down as the resulting rise in debt-servicing costs could expose weaknesses in the corporate sector and Bank Indonesia may need to raise rates significantly to prevent a sharp depreciation of the rupiah.</td>
</tr>
<tr>
<td>A sharp slowdown in China</td>
<td>Indonesia’s exports would be hit directly and indirectly by lower Chinese demand. Prices for most Indonesian commodity exports would fall, reducing public revenues.</td>
</tr>
<tr>
<td>Natural disasters</td>
<td>Indonesia is prone to natural disasters such as extreme weather, volcanic activity and earthquakes, which can entail large fiscal, economic and social costs.</td>
</tr>
</tbody>
</table>
Figure 8. Credit levels are low and banks are well capitalised overall

A. External debt securities

B. Foreign currency debt

C. External debt as % of GDP

D. External debt as % of exports

E. Banking sector ratios

F. Tier 1 capital adequacy ratio

G. Credit to the non-financial sector

H. Credit to the private non-financial sector

1. Median of OECD countries.

Note: Panels B, C and D are as at 2018Q1; Panel F is the average of 2017Q2 to 2018Q1 or the latest available; Panel H is the average for 2017.

Source: BIS, Global Liquidity Indicators Database; World Bank, External Debt Statistics Database; OECD, OECD Economic Outlook Database, Resilience Database; OECD calculations.

StatLink 2 https://doi.org/10.1787/888933832894
Monetary policy is contributing to macroeconomic stability

Diminishing inflationary pressure allowed Bank Indonesia to ease monetary policy over 2016-17 by 200 basis points to support growth (Figure 9, Panel A). Initially it responded to capital outflows in 2018 by selling foreign reserves, but in May it began raising policy rates, hiking by a total of 150 basis points by September (Panel B). Bank Indonesia’s mandate is to maintain stability in the value of the rupiah, in terms of goods and services (as reflected by the inflation rate) as well as relative to other currencies. It has been given independence to undertake these tasks and pursue its inflation target. As US monetary policy normalises, interest rates will need to rise further to manage exchange-rate pressure, achieve the inflation target and maintain economic stability. Bank Indonesia has emphasised its readiness to act pre-emptively. Permitting the rupiah to depreciate gradually would reduce the steepness of the required policy tightening. Continuing to co-ordinate policy across financial regulators should help maintain investor confidence. In 2020 the inflation target range will again be lowered by 1/2 percentage point, reducing Bank Indonesia’s room for manoeuvre.

The domestic effects of tighter monetary policy could be lessened by maintaining downward pressure on lending rates, either by reducing funding costs for banks or narrowing the spread between bank deposit and lending rates. Indeed, the spread between bank deposit and lending rates – over 500 basis points in 2017 – has been wide for many years and wider than in neighbouring countries. A range of factors contribute to the spread including higher costs of a banking network due to Indonesia’s geography, under-developed money markets and inefficiencies. Competition from the growing fintech sector may help push down lending rates. More liquid money markets could lower bank funding costs. Developing money markets will help, including the recent introduction of a new benchmark overnight rate, and encouraging repurchase agreements and interest rate swaps as planned. Bank reserve requirements are being relaxed to provide greater flexibility in liquidity management and lower bank funding costs. Going forward, to increase financial stability systemically important banks will be required to hold additional capital from 2019.

Figure 9. Interest rates and reserve asset sales have been used to stabilise the rupiah
Deepening and broadening financial markets and access

The bond market is still relatively small and dominated by government issues (Figure 10, Panel A). There is also room to improve liquidity (Panel B). Likewise, stock-market capitalisation is only 46% of GDP, which is lower than in some peers. Deeper local capital markets would help fund investment and bolster financial resilience (Table 3). This requires overcoming obstacles and challenges such as: lengthy and costly issuance procedures; a small domestic investor base; exchange-rate risks and high withholding taxes on interest income for residents from outside of tax-treaty countries, which deter foreign investors; and the need for more co-ordination among regulators and with the private sector (WEF, 2016). A national strategy for financial-market development has started to be implemented and a new overnight benchmark rate, the “IndONIA”, has been launched. Streamlining procedures and regulations and aligning them with international practices should increase the supply of corporate bonds. Adopting international principles for financial products, developing reference rates and hedging products, and improving creditor protection would boost investor demand (IMF, 2018; WEF, 2016). Market participants and investors should be consulted before new regulations are implemented.

Figure 10. The local-currency bond market is still small and illiquid

A. Bond market size

B. Average bid-ask spread in local currency government bond market

Note: Data are for 2018Q2 or latest available.
Source: Asian Development Bank, AsianBondsOnline

Table 3. Past recommendations related to financial markets

<table>
<thead>
<tr>
<th>Recommendations in previous Surveys</th>
<th>Action taken since the October 2016 Survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deepen and broaden financial markets by making more room for non-banks and the stock market in financing the economy.</td>
<td>In 2017 mechanisms for securitising state-owned enterprise infrastructure assets were implemented to help finance strategic infrastructure projects. In 2018 the authorities relaxed foreign investment restrictions in the insurance sector which is expected to increase investor demand for domestic equities and bonds.</td>
</tr>
<tr>
<td>Further develop the foreign exchange market by reducing the role of Bank Indonesia, generalising hedging and options, and enlarging the class of assets underlying the transactions.</td>
<td>The authorities launched the Global Master Repurchase agreement and introduced a version of the International Swap and Derivatives Association contract. The foreign exchange regulatory framework has been revised. Call spread options are now allowed for hedging.</td>
</tr>
</tbody>
</table>
The government also aims to deepen Islamic financial markets by promoting issuance of compliant instruments and Islamic banking. Islamic banks represent just 6% of bank assets, which is comparable to the share in Turkey but well below the 25% share in Malaysia (IFSB, 2017). Indeed, Malaysia’s example illustrates the potential in Indonesia (Box 1). Growth in this segment is now outpacing that of conventional banks. Developing Islamic banking could help diversify sources of finance as well as saving. To safeguard financial stability, regulators should ensure that capital requirements are in line with those applying to conventional banks and establish the planned early warning system (IMF, 2017a). Financial education could help increase investor awareness and understanding of these new products.

**Box 1. Malaysia’s experience with Islamic banking**

Islamic finance operates according to the principles of Islamic law, which prohibits usury and promotes risk-sharing and participatory asset-backed financing. Therefore, rather than loans, Islamic banks use non-interest-bearing instruments to fund investment and working capital. For example, they purchase the intermediate inputs or machinery on the customer’s behalf and “lend” them to the customer until the loan is repaid. The bank earns a profit margin on the difference between the purchase price of the input or machinery and the price repaid by the customer. Within three decades, Malaysia has developed a competitive, liberal and globally recognised Islamic finance ecosystem that operates alongside the conventional financial system. Islamic banking assets expanded from 0.07% of domestic banking assets in 1994 to 30% by end-2017 (BNM, 2018; Caporale et al., 2016). In the first half of 2016, Malaysia accounted for 9% of global Islamic banking assets (IFSB, 2017).

Islamic banking initially began with Islamic windows set up inside conventional banks. From 2005 standalone Islamic banks were created. The investment intermediation role of Islamic banks was later strengthened through the offering of investment accounts. An “Investment Account Platform” was subsequently launched as a marketplace to match investors with projects that suit their risk appetites. New Islamic banking licences have also been issued to six foreign banks to promote Malaysia as a global Islamic financial hub.


Financial inclusion is improving. The share of adult Indonesians with a financial institution account rose from 36% to 48% between 2014 and 2017, as rural areas caught up (Demirgüç-Kunt et al., 2018). The authorities have adopted a range of programmes to lift financial inclusion. They have promoted digital financial services by shifting some social transfers from in-kind benefits to cash and also e-money (as part of the Cashless Society Programme). Other programmes work with different stakeholders to broaden their reach, for instance branchless banking is promoted through the “Laku Pandai” programme that provides access to simple financial services through agents (Box 2). Nonetheless, access to a saving account is still lagging other countries (Figure 11, Panel A). Cash dominates transactions, and wage-earners are typically paid in cash. The new National Payments Gateway will facilitate greater use of electronic payments. Transactional accounts with wage inflows would provide a credit record, enhancing access to finance. Insufficient funds and distance are common reasons for not having an account (Demirgüç-Kunt et al., 2018).
Programmes such as “Laku Pandai” can help address these challenges but require greater awareness and training of agents, plus improvements in telecommunications and internet infrastructure (LPEM, 2017).

### Box 2. Examples of programmes to increase financial inclusion in Indonesia

The authorities have launched a range of programmes engaging with different stakeholders and focusing on different aspects of financial inclusion. For example:

- The “Laku Pandai” programme aims to provide simple financial services such as bank accounts, micro credit and micro insurance through agents – a form of “branchless banking”. As of December 2017, it covered 13.6 million customers in 27 banks compared to 3.7 million in 20 banks a year before.

- “SimPel” and “Simpel B” are student savings programmes with simple accounts at conventional and Islamic banks, respectively. They are operated in conjunction with the banking sector. By March 2018, there were 11 million accounts at over 214,000 schools.

- The “Team to Accelerate Regional Financial Access” programme (TPAKD) aims to build co-ordinating forums at the local level to accelerate financial access in regional areas. The teams comprise government institutions and local stakeholders. By March 2018, there were 31 teams at the provincial level and 35 teams at the municipal level.

*Source:* Bank Indonesia; Financial Services Authority (OJK).

### Figure 11. Some measures of financial inclusion still lag other countries

Per cent of population aged 15 years or over

#### A. With a financial institution account

<table>
<thead>
<tr>
<th>Country</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>IND</td>
<td>80</td>
<td>60</td>
</tr>
<tr>
<td>CHN</td>
<td>70</td>
<td>50</td>
</tr>
<tr>
<td>BRA</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>ZAF</td>
<td>50</td>
<td>30</td>
</tr>
<tr>
<td>PHL</td>
<td>40</td>
<td>20</td>
</tr>
</tbody>
</table>

#### B. Borrowed from a financial institution in the past year

<table>
<thead>
<tr>
<th>Country</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>IND</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>CHN</td>
<td>15</td>
<td>7.5</td>
</tr>
<tr>
<td>BRA</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>ZAF</td>
<td>5</td>
<td>2.5</td>
</tr>
<tr>
<td>PHL</td>
<td>2.5</td>
<td>1.25</td>
</tr>
</tbody>
</table>


[StatLink](https://doi.org/10.1787/888933832951)

Indonesia’s microfinance sector has grown in prominence, led by banks, as noted in previous *Surveys* (OECD, 2012a). Indeed, borrowing from a financial institution is more common than in some comparable countries (Figure 11, Panel B). The government has
taken many measures to increase SME access to finance (OECD, 2018a). These have mostly been bank-focussed and include expanding the subsidised SME lending programme with partial guarantees (KUR) and steadily increasing the floor for bank SME lending to 20% of loans, with administrative penalties for non-compliance. A new programme (“UMi”) offers short-term low-interest-rate loans to micro-enterprise borrowers who are too small to qualify for the KUR programme. Policies to promote bank lending to SMEs may have unintended consequences, such as increasing non-performing loans or reducing competition in the banking sector (OECD, 2018a). Non-performing loans under the KUR programme are currently low but should be monitored and the effect of subsidised loans on SME performance should be evaluated. The rapid expansion of peer-to-peer lending is providing SMEs with an alternative to bank finance, with over 60 domestic and foreign fintech lenders registered in June 2018. Further developing credit bureaus may also facilitate access to finance from bank and non-bank lenders alike (OECD, 2018a).

Fiscal policy is sound, but public spending is constrained by low revenues

Indonesia’s fiscal stance is prudent thanks to the 2003 Fiscal Law, which caps the deficit at 3% of GDP and debt at 60% of GDP. Since 2015 the government has matched slower growth in revenues with expenditure containment to keep the deficit around 2.5% of GDP (Figure 12). To create a larger buffer vis-à-vis the legislated deficit ceiling, it plans to narrow the deficit slightly in 2018 and 2019 to just under 2% of GDP. Given the uncertainty in financial markets this is sensible, but the effectiveness of spending should be improved, as discussed below, to limit the drag on growth from this and tighter monetary policy. More prudent revenue forecasts have enhanced fiscal credibility and spending efficiency by avoiding cuts late in the year. The spending mix improved in 2017, with personnel outlays increasing by 2.5% while capital expenditure expanded by 23%.

Figure 12. The central government deficit has widened but remains within the legislated limit

<table>
<thead>
<tr>
<th>Fiscal balance (right scale)</th>
<th>Expenditure (left scale)</th>
<th>Revenue (left scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of GDP</td>
<td>% of GDP</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>-5</td>
<td>-1</td>
<td></td>
</tr>
<tr>
<td>-10</td>
<td>-2</td>
<td></td>
</tr>
<tr>
<td>-15</td>
<td>-3</td>
<td></td>
</tr>
</tbody>
</table>

Source: CEIC; Ministry of Finance; OECD, *OECD Economic Outlook Database*.

Government debt is low

At 29% of GDP Indonesia’s general government gross debt is low relative to other emerging economies and well below the 60%-of-GDP legal limit. Interest payments crept up to 1.6% of GDP in 2017 due to higher debt and a higher effective interest rate. The large share of foreign-currency-denominated debt means that rupiah depreciation raises
financing costs (although depreciation also boosts oil-related revenues). The deficit cap, as long as it holds, means that even a large shock to interest payments would not raise debt to unsustainable levels but would crowd out other spending, even if growth remains solid (Figure 13). Otherwise, even with a larger primary deficit, debt is unlikely to rise substantially, absent extreme but low-probability shocks, such as natural disasters or bailing out a large public firm.

**Figure 13. General government debt scenarios**

Note: In all scenarios GDP growth and inflation are in line with OECD Economic Outlook projections to 2019. The baseline scenario assumes constant GDP growth of 5% and inflation (in the GDP deflator) of 3.2% from 2020. The primary budget deficit is 0.5% from 2019. The effective interest rate is 6% from 2023. The "larger primary deficit" is an alternative scenario that assumes a primary deficit of 0.8% of GDP from 2019 onwards. In the "higher interest rate" scenario, the effective interest rate is assumed to rise by 150 basis points by 2021 and from 2020 the primary deficit is the difference between the 3% cap and interest payments. Source: OECD, OECD Economic Outlook Database; IMF, World Economic Outlook Database; OECD calculations.

StatLink [https://doi.org/10.1787/888933832989](https://doi.org/10.1787/888933832989)

Although low relative to GDP, Indonesia’s government debt appears more vulnerable to large shocks than some other emerging economies, partly due to foreign exposure but also the fact that debt-servicing costs have also tended to be relatively high (OECD, 2016a). Government debt was equivalent to around twice revenues in 2017, which is similar to many emerging economies, where raising revenues is generally more difficult. Recent research on debt limits highlights how the government could increase resilience (Box 3). While the government cannot control market volatility, it can improve regulatory quality and fight corruption at all levels, which can lower risk premia (OECD, 2018b). Exports can improve resilience by better covering debt financing. Continued improvements to logistics and finalising pending free trade agreements with the European Free Trade Association and Iran could boost exports. An agreement with Australia was concluded in August 2018. Indonesia is also considering joining the Trans-Pacific Partnership with five other ASEAN members who are not signatories, which would mitigate any trade diversion effects from being outside the agreement.
Box 3. Determinants of debt sustainability and risk premia

Recent OECD research sheds light on the non-linear relationship between a country’s debt level and its risk premium, which is in turn a function of the probability of default (Fournier and Bétin, 2018). Focussing on middle-income countries, Fournier and Bétin estimate: (i) a “safe” range of debt ratios, within which the interest rate returns to equilibrium following a transient interest-rate shock without threatening fiscal sustainability; and (ii) a range of debt ratios in which a sufficiently high interest-rate shock may push the country onto a self-fulfilling path towards default. The upper limit therefore is the estimated debt limit beyond which a shock pushes a country to default.

The estimated debt levels are of course subject to some uncertainty and should be treated with caution. But the exercise highlights country-specific factors that are associated with higher “safe” debt ranges, namely: more effective government; a higher export share in GDP; higher GDP growth; lower volatility of growth; and an absence of default in neighbouring countries.

The estimated “safe” debt range is narrower in Indonesia than other middle-income countries (Figure 14). The gap with other countries is mostly due to lower-than-average export shares, even allowing for Indonesia’s size, and relatively poor perceptions of government effectiveness, although the latter has improved markedly (Figure 15). This is consistent with panel regressions on the determinants of risk premia in OECD and emerging economies that highlight the role of regulatory quality, as well as the level of government debt and global financial-market volatility (OECD, 2018b).

Figure 14. Debt is low, but so is the estimated debt limit

Note: The debt ranges are calibrated for a risk-neutral investor, a recovery rate after default of 50% and a risk-free interest rate of 3%. The estimates are based on smoothed data.

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Finding funds for development-related spending is a challenge

Against this background, the biggest fiscal challenge is funding spending that will boost long-term growth and improve well-being. Indonesia’s infrastructure gaps – particularly in transport, logistics and water treatment – add to costs and limit access to services, constraining development (OECD, 2016a). In 2015 the government capital stock was equivalent to just 39% of GDP, compared to 92% across emerging economies (IMF, 2017b). Likewise, government provision of health and social assistance is currently low (Figure 16). Social protection systems are expanding and will require additional funding during this process (OECD, forthcoming). To fully implement universal healthcare coverage and ensure social assistance programmes reach the poor and vulnerable would require additional annual spending equivalent to 1.4% of GDP (World Bank, 2018a). As Indonesia’s income grows over the next decade, so will expectations of social services. Applying the public social spending of OECD emerging economies to Indonesia’s projected demographics would imply a substantial expansion in social programmes and spending as a share of GDP in 2030 (Table 4).
Figure 16. Social spending is still relatively modest

2016 or latest available


StatLink https://doi.org/10.1787/888933833046

Table 4. Demands for public spending will likely increase as income rises

<table>
<thead>
<tr>
<th></th>
<th>Current spending (% of GDP, 2016)</th>
<th>Potential spending demands in 2030 based on OECD emerging market economies (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health</td>
<td>1.5</td>
<td>4.2</td>
</tr>
<tr>
<td>- All health spending</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social protection</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td>- Old-age pension</td>
<td></td>
<td>5.7</td>
</tr>
<tr>
<td>- Disability and sickness cash benefits</td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>- Family benefits including early childhood education and care</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>- Active labour market programmes</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>- Unemployment benefits</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>3.6</td>
<td></td>
</tr>
<tr>
<td>- Primary, secondary and post-secondary non-tertiary education</td>
<td>2.5(^1)</td>
<td>3.6</td>
</tr>
<tr>
<td>- Tertiary education</td>
<td>0.6(^1)</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Note: Estimates for family benefits, active labour market programmes, old-age pensions and education are based on spending-to-GDP ratios adjusted for projected relevant population shares in 2030. Other estimates are simple averages. The economies used for comparison are: Chile; Hungary; Mexico; Poland and Turkey.

1. In 2015.


Given the difficulty of raising revenues, increasing the efficiency of public spending – as highlighted in the previous Survey – remains a high priority for freeing up funds (OECD, 2016a). The energy subsidy reforms of 2014–17 contributed to a 14 percentage point fall in the share of government expenditure on energy subsidies, freeing up funds for infrastructure and better targeted social programmes. The shift from rice subsidies to e-vouchers for a wider variety of food is also in line with previous OECD recommendations.
Nonetheless, national accounts data indicate that total subsidies on production were still equivalent to 1% of GDP in 2017, compared to 0.6% in OECD countries. Energy subsidies are expected to increase by IDR 66 trillion (0.4% of GDP) in 2018, largely due to a larger diesel subsidy. Energy and fertiliser subsidies, which encourage overuse, should be replaced with more targeted support such as cash transfers for poor households and education and investment to raise agricultural productivity (OECD, 2016a; 2015b). Sub-national transfers are becoming better targeted, but more targeting and monitoring are still needed (Table 5). Costs associated with the expansion of health coverage will need to be controlled (OECD, forthcoming).

Agencies such as the national public procurement authority and the Corruption Eradication Commission (KPK) have crucial roles to play in reducing losses due to bribery and corruption. The previous Survey highlighted the importance of improving practices at sub-national governments. Recent reforms at local governments such as increasing e-procurement and strengthening their internal budgeting and controls go in the right direction (Table 5). The OECD Recommendation on Public Integrity and OECD Principles for Integrity in Public Procurement could help guide further reforms. As recommended in the previous Survey, the authority and resources of the KPK should be strengthened.

Table 5. Past recommendations for improving the efficiency of the public sector

<table>
<thead>
<tr>
<th>Recommendations in previous Surveys</th>
<th>Action taken since the October 2016 Survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improve corruption-prevention mechanisms, while further boosting efforts to combat all its forms. Support the Corruption Eradication Commission (KPK), and provide it with more resources and authority.</td>
<td>In 2017 the KPK launched e-LHKPN, an online reporting system to ease the process for government officials to report their assets and GOL KPK, an app for reporting gifts. Local governments are being encouraged to adopt technology that reduces the scope for corruption, such as e-procurement, and to strengthen internal budgeting and controls.</td>
</tr>
<tr>
<td>Move ahead with the implementation of performance-based budgeting (“money follows the programme”). Improve evaluation of existing and future programmes, and reinforce links with medium-term objectives.</td>
<td>The ‘Architecture and Performance Information’ (ADIK) application for ministries and institutions was implemented to improve the quality of budget allocation.</td>
</tr>
<tr>
<td>Revise the system of transfers from central to sub-national governments to remove the link with payroll. Reform the system of village transfers to account for population size and poverty prevalence for the basic allocation.</td>
<td>There is now a cap on the basic allocation component of the General Allocation Funds transferred to sub-national governments, which weakens the link with payroll expense. From 2018 the village transfers apportion weights to population (10%), number of poor people (50%), land area (15%) and degree of geographic difficulty (25%). Additional transfers are given to underdeveloped villages with many poor people.</td>
</tr>
<tr>
<td>Phase out all remaining energy subsidies. Phase out fertiliser subsidies in favour of the development of irrigation systems, rural infrastructure and research, and direct cash support to the poorest farmers. Replace RASKIN with food vouchers for the poorest.</td>
<td>During 2017 electricity subsidies were removed for non-poor households with 900 volt-ampere connections. However, energy subsidies have increased in 2018. In the 2018 Budget the government announced plans to shift Rastra (formerly RASKIN) recipients of rice to vouchers under the non-cash food aid (BPNT) programme.</td>
</tr>
</tbody>
</table>

State-owned enterprises (SOEs) are a key plank in the government’s infrastructure and development strategy. For instance, the 2016 plan to accelerate 245 national strategic projects assumed that 30% would be financed by SOEs’ investment. The 143 national-level SOEs operate in almost all sectors of the economy, ranging from manufacturing, construction and transportation to agriculture. SOEs are more pervasive across the economy than in any country in the OECD’s Product Market Regulation database except China. Listed SOEs represent almost one-quarter of equity market capitalisation. SOEs’ capital expenditures are targeted to reach almost 3% of GDP in 2018, more than twice their 2015 share. This was facilitated by government support, particularly capital injections in
2015-16 and a programme that encouraged them to revalue their assets. As SOEs have tapped capital markets, the leverage of some has risen dramatically (Reuters, 2018).

Financial vulnerabilities are rising at some SOEs. Rapid investment and higher leverage exposes SOEs involved with infrastructure projects to cash-flow difficulties, particularly if interest rates increase or projects are delayed. Measures to contain retail electricity and fuel prices are generating financial pressures for those firms. For example, the price of low-octane fuel (“premium”) has not been changed since 2016 despite the increase in the international oil price. In total 14 SOEs made losses in 2017, fewer than in 2016. State-owned banks’ exposures to SMEs and the construction sector have risen rapidly. On-balance-sheet loans and guarantees to SOEs are relatively small. Recognised contingent liabilities were only 0.01% of GDP in 2017, as these are confined to government-guaranteed loans. But the potential need for capital injections represents an indirect fiscal risk. Despite ongoing efforts to improve corporate governance, lack of transparency remains a concern (IFC, 2018).

Given these risks, monitoring SOEs and ensuring good governance are crucial. Plans to consolidate many SOEs into six sectoral holding companies are intended to improve efficiency but will probably make their financial situation more opaque. While all incorporated SOEs are required produce externally audited financial reports, these should be made publicly available and easily accessible to facilitate monitoring. Listing more SOEs would also improve corporate governance. An ownership policy could guide this process. Better disclosure could also help address concerns about integrity. Board members should be appointed in transparent nomination processes with limited political interference (IFC, 2018). Supervision by line ministries should be strengthened. Boards should also have clear mandates with sufficient independence to achieve these, as recommended in the OECD Guidelines on Corporate Governance of State-owned Enterprises. Greater attention should be given to the implicit risks from SOE losses and rising debt. Supervisors should be vigilant regarding credit quality of new loans from public banks.

Greater private-sector involvement in infrastructure projects would reduce the pressure on SOEs, but the private sector is being crowded out (World Bank, 2017). The government has increased the use of public-private partnerships (PPPs): in 2017 there were 11 PPPs underway, totalling USD 15.4 billion (World Bank, 2018b). Well-designed PPP projects with appropriately managed risks can harness the efficiency and expertise of the private sector (OECD, 2016a). However, prospective investors face legal and regulatory uncertainty and a lack of viable projects due to deficiencies in the project cycle (World Bank, 2017). SOEs sometimes act as “private” bidders which may also deter private investors (OECD, 2012b).

Several instruments have been created to attract more private sector interest in PPPs: “viability gap funding” (to subsidise capital costs); government guarantees (to cover government-related performance risks); “project development facilities” (to help prepare documentation such as feasibility studies); and “availability payments” (to increase certainty of cash flows by providing periodic payments for infrastructure services that comply with pre-agreed criteria). A stronger PPP unit and a more prominent role for the Ministry of Finance would help to manage PPP-related risks (OECD, 2016a; 2012b). But fundamental issues such as property rights, shallow capital markets and conflicting regulations should also be addressed. More generally, alternatives such as concessioning, asset recycling, asset securitisation and foreign direct investment should be promoted, including by revisiting the negative investment list (OECD, 2016b).
Raising revenues to meet spending needs

Falling non-tax revenues have weighed on overall revenue growth in recent years, largely due to lower receipts from resources such as oil. Consequently, the ratio of general government revenue to GDP declined to 14% in 2016 (Figure 17, Panel A). Tax revenues (12% of GDP according to the OECD’s definition) are particularly low relative to other countries at a similar income level, including Malaysia and the Philippines (Panel B). Higher commodity prices and improvements in compliance are expected to raise revenue-to-GDP ratios somewhat in 2018. Tax reforms that durably raise medium-term revenues would reduce exposure to commodity cycles and could push Indonesia into a higher-tax, higher-growth equilibrium (Gaspar, Jaramillo and Wingender, 2016). This depends on both raising compliance and improving tax design, as highlighted in the OECD’s 2012 Economic Survey (OECD, 2012a). Over 2012-16, the number of registered taxpayers rose by almost 12 million, but registration levels remain low by international standards (Table 6). Accordingly the government’s tax reform agenda includes actions to raise compliance, including through strengthening the tax administration and simplifying tax design.

Figure 17. Fiscal revenues have been low

Note: Tax revenue data are based on the OECD’s definition of tax revenues and can differ from national definitions. In Panel A the diamonds exclude revenue equivalent to 0.8% of GDP raised during the tax amnesty for individuals and firms that began in July 2016. Data for Indonesia do not include social security contributions; those that would be classified as tax revenue are estimated to total less than 0.5% of GDP. In Panel B data are for 2016 or latest available.

Source: OECD, Revenue Statistics Database, OECD Economic Outlook Database; World Bank, World Development Indicators Database; IMF, World Economic Outlook Database; World Bank (2018), Indonesia Economic Quarterly: Towards Inclusive Growth, World Bank, Jakarta.

StatLink https://doi.org/10.1787/888933833065

Upgrading tax administration and increasing enforcement are priorities

The main tax administration is the Directorate General of Taxes (DGT), which sits within the Ministry of Finance but has offices around the country. Restructuring the administration and developing its human resources are part of the tax reform agenda. Spending on staff has been low in the past but by 2016 had risen to be comparable with other non-member countries (Table 6). It rose further in 2017. The number of employees is low relative to the number of adults, although it is higher relative to the number of taxpayers. However, the administration has been expanding its workforce and investing in training existing staff. Nonetheless, auditors, analysts and IT professionals are in short supply. Further training will be crucial in strengthening the administration and enabling staff to adapt to new technologies and challenges. Hiring and reallocation are needed but hampered by public-
sector staffing regulations. Giving the DGT temporary authority to make more transformative staffing changes (with oversight) could accelerate the pace of change.

Table 6. Tax administration performance and resources

<table>
<thead>
<tr>
<th>Indicators of performance</th>
<th>Indonesia</th>
<th>Non-OECD average</th>
<th>OECD emerging market economies</th>
<th>OECD average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registered personal income taxpayers (% of population 15+ years)</td>
<td>Between 17.8 and 36.7</td>
<td>56.1</td>
<td>73.6</td>
<td>87.6</td>
</tr>
<tr>
<td>On-time filing (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Personal income taxpayers</td>
<td>60.6</td>
<td>78.6</td>
<td>63.5</td>
<td>90.6</td>
</tr>
<tr>
<td>- Corporate income taxpayers</td>
<td>57.6</td>
<td>71.9</td>
<td>59.8</td>
<td>84.5</td>
</tr>
<tr>
<td>On-time payment – value-added tax (%)</td>
<td>86.0</td>
<td>90.4</td>
<td>-</td>
<td>93.3</td>
</tr>
<tr>
<td>Indicators of resources</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Citizens (15+ years) per staff member</td>
<td>4,893</td>
<td>3,030</td>
<td>1,917</td>
<td>1,269</td>
</tr>
<tr>
<td>Active personal income taxpayers per staff member</td>
<td>446</td>
<td>562</td>
<td>1,065</td>
<td>635</td>
</tr>
<tr>
<td>Total budget as % GDP</td>
<td>0.08</td>
<td>0.12</td>
<td>0.14</td>
<td>0.19</td>
</tr>
<tr>
<td>Staff costs as % total recurrent budget</td>
<td>61.0</td>
<td>64.3</td>
<td>74.9</td>
<td>72.6</td>
</tr>
<tr>
<td>Training costs as % total recurrent budget</td>
<td>0.4</td>
<td>0.3</td>
<td>1.2</td>
<td>0.5</td>
</tr>
<tr>
<td>IT budget as % total recurrent budget</td>
<td>3.3</td>
<td>11.0</td>
<td>3.8</td>
<td>13.4</td>
</tr>
</tbody>
</table>

Note: Data are for 2015 except for data for Indonesia on registered PIT taxpayers and staff costs, which are for 2016. The number of countries covered varies with response rates to the questionnaire, up to 55 countries. OECD emerging market economies is the average of Chile, Hungary, Mexico, Poland and Turkey; the average is not shown where there is only data for one country.
1. Calculated from data provided by the Directorate General of Taxes. Registered taxpayers are at end 2016. Note that married individuals typically pay tax at the household level; the lower bound is calculated by adjusting the number of taxpayers for the share that file tax jointly and the upper bound assumes that every taxpayer represents a two-taxpayer household.


Information systems are ageing but are being modernised as part of the reform agenda. This can promote compliance by lowering costs for taxpayers and raising the probability of detection. E-filing rates for income tax have risen to 82% in 2017, but experience from Brazil and Mexico shows 100% is attainable. Filing and payment can be made easier through pre-filled returns and reminders, for example. The 2016-17 tax amnesty and Automatic Exchange of Information from September 2018 add to the vast quantity of data to protect and process; detecting non-compliance is critical to reinforce the success of the amnesty. In 2018 the government plans to begin procurement of a “core tax administration” system that will capture all business processes including compliance system management and taxpayer account management. The procurement process should be open and implementation risks carefully managed.

Complexity and uncertainty add to compliance costs and increase opportunities for tax avoidance. The burden of paying tax appears more costly, in terms of time, than in other emerging economies, notwithstanding improvements in recent years (World Bank / PwC, 2018). The tax regime is still perceived as more contradictory and less consistently enforced than in most regional comparators even though it is perceived to have improved (Deloitte, 2017). Policy changes are frequent, which is partly due to changing circumstances but also because insufficient consultation leads to further changes. Simplifying the tax code, as planned, and reducing the frequency of changes would ease compliance costs. Broader public consultations on draft legislation would improve the quality of legislation. To build
an evidence base for future reform, the tax reform team could be tasked with consulting stakeholders and the public on policy reforms and publishing reports on these, as the Davis Tax Committee did in South Africa (OECD, 2015c). Planned changes to the tax administration’s website are expected to make it more user-friendly. Clear and simple explanations of current obligations and online calculators, for example, would assist taxpayers in complying. Greater use of risk-based auditing would improve efficiency and perceptions of fairness.

**Taxes can be broader and more inclusive**

Around half of all tax revenue is raised from income taxes and a further 30% from value-added tax. Other taxes include tobacco excise, trade taxes and local government taxes. Overall, the structure is similar to that of other emerging market economies but the level of revenues raised from key tax bases – corporate income, labour and goods and services – is lower (Figure 18). This suggests that higher revenues from all major taxes should be possible.

With low incomes and high rates of informality, the current personal income tax net includes few individuals and raises little revenue. Due to large increases in the basic tax allowance, Indonesian workers start paying a marginal tax rate of 5% when their gross income is around twice the average employee’s earnings (or more if they have dependents). Social security contributions apply to all workers but are relatively low (and not included in Figure 18). Compared to other large emerging economies, marginal tax rates at medium-to-high incomes are low (Figure 19). This also limits the progressivity of the system: in 2016 an individual hit the 30% marginal tax rate only when their gross income was more than 20 times average earnings. Holding the basic tax allowance constant over time would see more workers gradually join the system. Lowering the top two brackets would make the system more progressive and raise more revenue. The administration would need to monitor the effects of these changes on compliance to ensure they do not increase informality or avoidance.

**Figure 18. Most components of tax revenue are lower than in other countries**

As a percentage of GDP, 2016 or latest

![Figure 18](https://doi.org/10.1787/888933833084)

*Note:* Tax revenue data are based on the OECD’s definition of tax revenues and can differ from national definitions. Data for Indonesia do not include social security contributions; those that would be classified as tax revenue are estimated to total less than 0.5% of GDP. Data for Indonesia for 2016 include the effects of the tax amnesty, which added 0.8% of GDP to revenue in 2016.

Unequal treatment of different forms of income reduces the tax base and complicates the system. In particular, fringe benefits and allowances paid by employers are untaxed under the personal income tax system (but employers may not deduct them as expenses). This is regressive, as such benefits are more likely to accrue to those on higher incomes and so should be taxable income. Discussions are underway to recognise these benefits as personal taxable income and in turn recognise them as expenses for corporate income tax. Individuals’ investment income is also taxed at different rates depending on the source. This can distort saving decisions and create tax planning opportunities. The 10% tax rate on real estate rental income is far below the 20% rate on bank interest, creating a strong incentive to invest in real estate. The rate schedule should be reviewed to reduce such disparities.

Indonesia’s statutory corporate income tax rate of 25% is roughly in line with G20 and OECD averages. In recent years tax incentives have been expanded to attract investment. In April 2018 the government widened the eligibility for tax holidays to 17 specified “pioneer” industries (including oil and gas refining, machinery manufacturing and economic infrastructure) and simplified the application process. The holidays range from 5 to 20 years, depending on investment size. There are also tax holidays and other incentives in designated zones and tax allowances for 145 business segments. Experience from other countries suggests that tax holidays are often ineffective in raising investment because the broader issues hampering investment remain or foreign investment displaces domestic investment (IMF / OECD / UN / World Bank, 2015; IADB, 2013). Moreover, tax holidays (and special economic zones) create tax planning opportunities, distort competition and create the potential for policy capture and corruption (OECD, 2018c; 2012a; IADB, 2013).

Rethinking tax incentives could broaden the tax base and be more effective in promoting investment. The publication in late September 2018 of detailed tax expenditure estimates
for 2016-17 increases transparency and is a welcome first step in evaluating the incentives. The tax expenditure report should continue to be improved and be published annually, as planned. Because many countries in the region offer tax holidays, Indonesia could lead a co-ordinated approach within ASEAN. It would be preferable to shift away from tax holidays to cost-based incentives (tax deductions or credits) linked to investment in capital or skills. Those incentives would better target new investment but would require ensuring sufficient administrative capacity to oversee them. All incentives should be monitored carefully to detect abuse and subject to a sunset clause to guarantee regular reviews. Investor concerns related to the regulatory environment would be better addressed directly rather than through the tax system.

A turnover tax for small businesses aims to encourage formalisation of small firms. Businesses in eligible sectors with annual turnover below IDR 4.8 billion (around USD 323 000 in September 2018) can opt into the scheme and pay a rate of 0.5%, which was halved from 1% in July 2018. The threshold for compulsory value-added tax (VAT) registration is also IDR 4.8 billion. By 2017 the turnover tax regime had already attracted 1.5 million registrants, of which 205 000 were incorporated and 1.3 million were individuals. However, the sheer number of SMEs in Indonesia means that increasing registration remains a challenge (Table 7). The regime’s cost has not yet been included in the tax expenditure report. Access to the turnover tax is limited to three years for incorporated firms, and to seven years for individuals. The time limit aims to avoid creating disincentives to grow but it will disadvantage firms that do not have the capacity to comply with the standard tax system.

Regional tax offices are increasingly offering services for SMEs. Linking the turnover tax to additional benefits such as access to business development services, book-keeping assistance and applications, and simplified administrative procedures could encourage formalisation. To contain costs, eligibility for the tax should be restricted to very small firms. Such comprehensive programmes increased registration in Mexico, Brazil and Colombia. Micro enterprises should be allowed to remain on the simplified scheme.

### Table 7. Micro enterprises dominate the business landscape

<table>
<thead>
<tr>
<th>Categorization</th>
<th>Cut-off values for each category (IDR)</th>
<th>By number</th>
<th>By employment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net assets (excluding premises)</td>
<td>Annual revenue</td>
<td>Thousand</td>
</tr>
<tr>
<td>Micro enterprises</td>
<td>50 million</td>
<td>300 million</td>
<td>23 884</td>
</tr>
<tr>
<td>Small enterprises</td>
<td>500 million</td>
<td>2.5 billion</td>
<td>2 399</td>
</tr>
<tr>
<td>Medium enterprises</td>
<td>10 billion</td>
<td>50 billion</td>
<td>412</td>
</tr>
<tr>
<td>Large enterprises</td>
<td>35</td>
<td>0.1</td>
<td>8 547</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>26 711</td>
</tr>
</tbody>
</table>

**Note:** Data are for establishments in 2016 and exclude the agriculture, forestry and fisheries sector, government administration, defence and social security sector, and household activities as employers or own production sector. Unregistered businesses are included.

**Source:** Statistics Indonesia, Economic Census 2016.

**Taxes on goods and services could be more efficient**

Value-added tax (VAT) revenues have been increasing in recent years. This is welcome, given that base's potential to be a comparatively efficient source of revenue (Akgun, Courrède and Fournier, 2017; Acosta-Ormaechea and Yoo, 2012). There is a single rate of 10%, but numerous exemptions and a high threshold for registration reduce the VAT's
efficiency and effectiveness considerably. In addition to exemptions for specific basic foods and common exemptions (such as education), there are exemptions for “strategic” intermediate inputs, services subject to local sales taxes (hotels, restaurants, entertainment, parking), certain resource-related products, and services supplied to local shipping firms. Exemptions weaken the efficiency of VAT, because the tax cascades, (OECD/KIPF, 2014) and self-enforcement, because the purchaser has no incentive to demand a VAT invoice. The high threshold for registration significantly reduces the share of firms participating in the system and therefore reinforcing compliance.

A comprehensive VAT reform could broaden its base and increase its effectiveness. Exemptions for services that are subject to the 10% local sales taxes (such as hotels and restaurants) and intermediate inputs should be removed to harness the self-enforcement properties of VAT. The corresponding local sales taxes should be eliminated and local governments compensated for lost revenue via transfers. While changing the local sales tax would likely be difficult because it would require changing the laws related to decentralisation, it would benefit the firms in these sectors because they could claim back the VAT paid on inputs. Local governments could be permitted to charge a small accommodation tax, which would incentivise them to develop tourism. Because the exemptions for basic food items generally benefit lower-income households (with the exception of meat), these could be zero-rated until the social protection system is able to provide similar targeting (Figure 20).

The VAT legislation is currently under review. A package of reforms that: (i) replaced most exemptions with the standard rate; (ii) replaced exemptions on basic necessities with a zero rating; and (iii) reduced the threshold for compulsory registration to be in line with international norms, would broaden the tax base. It should be accompanied by strengthened administration of the VAT. IMF estimates imply that removing exemptions may lead to an initial fiscal cost of 0.1% of GDP because inputs could be claimed back (IMF, 2017c). But the reform would bring more firms into the VAT system which should raise revenues and the broader base would lay the foundation for efficiently raising more revenue in the future via a higher VAT rate.

Figure 20. VAT exemptions for food generally benefit poorer households

Note: Data are for 2016. Salt and soybeans are also exempt from VAT but are not shown here. In Panel B food items are ordered by the spending of the poorest households.

Source: Statistics Indonesia.

StatLink ➤ https://doi.org/10.1787/888933833122
Excise taxes can be efficient tools for curbing behaviours with high social or long-term costs, such as smoking (WHO, 2017). Indonesia has particularly high smoking rates among men (but among the lowest for women) and is one of the few countries with a rising smoking rate (Figure 21 Panel A) (OECD, 2017a). Given smoking’s well-recognised health costs and the future financial burden on the health system, reducing smoking should be a priority. The most popular packet of cigarettes was taxed at a rate of 57% in 2016, which is the maximum tariff allowed under the excise law but below the WHO guideline of 70% and other countries’ rates (Panel B). Taxes vary across products; for instance, excise is lower on hand-rolled cigarettes. Excises should be increased, rates harmonised across products and awareness of health costs raised.

**Figure 21. Tobacco use is high, and taxes are relatively low**

<table>
<thead>
<tr>
<th>A. Percentage of population smoking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
</tr>
<tr>
<td>Female</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B. Total taxes as a % of price of the most sold brand</th>
</tr>
</thead>
</table>

Note: “EME” is an unweighted average of the emerging market economies shown. Data in panel A are for 2015 and in panel B for 2016.


The government is considering a tax on sugar-sweetened beverages to help combat rising rates of diabetes and other non-communicable diseases. Such taxes reduce consumption and, if set sufficiently high, can have positive health outcomes (Thavorncharoensap, 2017). If introduced, it should be part of a broader campaign to counter lifestyle-related diseases.

Environmentally-related taxes can be efficient tools for reducing emissions of pollutants and road congestion. OECD estimates suggest that such taxes are equivalent to less than 1% of GDP in Indonesia. Compared to OECD countries, Indonesia raises sizeable revenue from motor vehicle taxes but little from energy use (Table 8) (OECD, 2018d). There is substantial scope to adjust motor vehicle taxes so that environmental impacts influence purchasing decisions. The World Bank and Ministry of Finance estimated that converting the luxury goods sales tax on vehicles to a specific tax and changing the rates according to environmental impacts could raise the equivalent of 0.6% of GDP (World Bank, 2018a). The annual motor vehicle levy could be converted to a flat tax that varies based on car types and their emissions, rather than being linked to value, which declines over time. A gradual shift to more cost-reflective pricing of energy would help users internalise costs associated with its use. A first step would be to phase out subsidies, as discussed above.
Table 8. Key environmentally-related taxes

<table>
<thead>
<tr>
<th>Tax</th>
<th>Tax base</th>
<th>Level of government</th>
<th>Maximum rate allowed</th>
<th>Revenue as % of GDP, 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Vehicles</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Motor vehicle taxes (annual</td>
<td>Value of motor vehicles</td>
<td>Sub-national</td>
<td>5% for annual tax, 10% for transfers</td>
<td>0.5</td>
</tr>
<tr>
<td>registration fee, transfers)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Luxury goods sales tax</td>
<td>Imports and domestic motor vehicles</td>
<td>Central</td>
<td>200%</td>
<td>0.01</td>
</tr>
<tr>
<td><strong>Energy use</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Motor vehicle fuel tax</td>
<td>Fuel consumption of motor vehicles</td>
<td>Sub-national</td>
<td>5%, 7% in some regions</td>
<td>0.1</td>
</tr>
<tr>
<td></td>
<td>excluding VAT</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Street lighting tax</td>
<td>Electricity consumption of</td>
<td>Sub-national</td>
<td>1.5%, 3%, 10%</td>
<td>0.1</td>
</tr>
<tr>
<td></td>
<td>households and businesses</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note. Import tariffs on motor vehicles are not included.


Property tax could yield medium-term revenue gains

Property taxes are levied by central and sub-national governments. OECD estimates suggest that they are equivalent to around 0.4% of GDP, which is low in international comparison (Figure 22). Most revenue comes from recurrent tax on immovable property (land, buildings and other structures), and most of this is from natural resources-related properties, rather than residential or commercial real estate. There are also transactions-based property taxes. Although part of the recurrent tax on immovable property is decentralised, notably taxation of residential and commercial land and buildings, national legislation sets out a minimum exemption and a maximum rate of 0.3%. But these taxes have also been found to be far below their revenue-maximising level, given current legislation (von Haldenwang et al., 2015).

Figure 22. Property taxes raise little revenue

Note: Data are for 2016 or latest. Data for Indonesia are from national sources. OECD is an unweighted average of OECD member countries. Data for China, India and Russia are for 2009, 2009-10 and 2010, respectively and taken from Prakash (2013).


StatLink 2 https://doi.org/10.1787/888933833160
There are strong arguments for raising more revenue from recurrent tax on immovable property. It can in principle raise revenue for local governments (thereby strengthening their accountability) in a more economically efficient way than other taxes and can contribute to greater progressivity (Akgun, Cournède and Fournier, 2017; Arnold et al., 2011). The latter is especially relevant given estimates that Indonesians’ wealth is concentrated in real estate (Credit Suisse, 2017). In Russia and South Africa, this tax raises revenue of around 1% of GDP (Figure 22). However, before rates are raised, it is important that local government property tax databases are up-to-date and that local administrations are able to update and maintain them. This will likely require further training by the central government, including in using available information systems, and assistance in improving the administration of taxes.

Reaping the demographic dividend

Indonesia’s youthful demographics are both an opportunity and a challenge. Half of the population is under 30 years old, and the working-age population is growing by around 2 million annually. Unlike in much of the world, the working-age population is projected to increase to 68% of the Indonesian population by 2030 (Figure 23). This alone boosts estimated potential GDP per capita growth by 0.3 percentage points annually until 2030 (Box 4). The challenge is to shift the job mix to high-quality, high-productivity jobs in the formal sector, which will grow incomes and government revenues, thereby enabling better services to be provided for current and future generations. This challenge is recognised in, for example, government plans such as the “Making Indonesia 4.0” roadmap, which aims to expand the manufacturing sector and raise labour productivity.

Figure 23. Indonesia’s working-age population is rising in the near term

Population aged 15-64 years as a percentage of the total population


StatLink: https://doi.org/10.1787/888933833179
Box 4. Long-run scenarios for Indonesia’s economy

The OECD’s long-term scenarios shed light on the forces driving growth over the coming decades (Guillemette and Turner, 2018). The baseline scenario assumes current trends continue, with some catch-up in variables such as educational attainment, gender employment gaps and total factor productivity. Gains in Indonesia’s GDP per capita are projected to slow after 2030, as the direct benefits of the demographic dividend pass and then as cohort effects that raise employment fade (Figure 24). Indonesia would probably become the world’s fourth-largest economy during the 2030s.

Figure 24. Decomposition of real GDP per capita growth to 2060

Baseline scenario, contribution in percentage points

Note: Educational attainment increases as recent gains across cohorts are extended into the future, which translates into an average increase of 2.7 years at school. The gender employment gap narrows from 30 to 22 percentage points.

Most workers are still informally employed

Informality remains pervasive: 93% of Indonesian firms are estimated to be operating informally (Rothenberg et al., 2016). New OECD analysis suggests that around 70% of workers are employed informally, close to the share in Peru but much higher than in Brazil (35%) (Figure 25, Panel A). This is around 10 percentage points lower than a decade ago (Panel B). The least educated are most likely to be working informally; women, youth and over 55-year-olds also appear more affected (Panel C). Informality is highest in the agriculture, construction and transport and storage sectors. The rate of informality outside of agriculture is estimated to be around 60%. Across countries, informal jobs are typically of lower quality, with lower productivity and therefore lower wages, fewer training opportunities and poorer working conditions (OECD, 2015d; La Porta and Shleifer, 2014).
Informality results from many interrelated factors, including: barriers to formally hiring employees; disincentives for firms or workers to operate in the formal sector and a perceived lack of benefits from doing so; and a lack of skills, as highlighted in previous Surveys (OECD, 2015a). Strict employment regulations and high costs discourage the hiring of low-skilled employees and add to temporary employment instead, which is associated with less training (Figure 26) (Allen, 2016). Minimum wages are high relative to the median wage and severance pay is also high in international comparison but in practice compliance rates are low (ibid). Severance pay aims to compensate for the lack of unemployment insurance, but workers are likely to draw on their pension savings. The OECD’s Employment Protection Legislation indicators highlight that allowed dismissals...
are comparatively narrow and more procedurally difficult than elsewhere. Administrative burdens deter business formalisation, despite recent progress. It still takes 22 days to start a business, compared to 76 in 2013, according to the Doing Business indicators, and ongoing compliance costs are burdensome.

Figure 26. Regulations governing employment and product markets are strict

A. Average redundancy cost, 2016

B. Flexibility of employment regulations, 2016

C. Minimum wage, % of median wage, 2017 or latest

D. Strictness of product market regulation, 2013

*Note*: Average redundancy cost is the cost of advance notice requirements, severance payment and penalties due. Flexibility of employment regulation is from the Economic Freedom Indices calculated by the Fraser Institute and ranges from 0 (low economic freedom) to 10 (high economic freedom). Product market regulation ranges from 0 (less regulated) to 6 (more stringent).


Lower but better-enforced employment protection would better serve workers and reduce disincentives to hiring formal workers. Easier employment regulations could be piloted in the special economic zones, with effects monitored closely before extending the policies nationwide. In particular, the procedures and circumstances for dismissal could be eased and high severance pay replaced by unemployment insurance with individual accounts (OECD, 2016a). Around half of the OECD member countries set discounted minimum wages for groups of workers, such as young people, that are most likely to be disadvantaged by high minimum wages (OECD, 2015e). Discounted minimum wages for youth should be introduced, as previously recommended, and could be trialled in special economic zones.
Although social security contributions are relatively low, the compliance burden for small firms could be eased by allowing quarterly payments.

Labour and product-market reforms could significantly increase formality and, through labour productivity, GDP per capita (Box 5). But the benefits of formality should be also promoted and the trade-off for formalising made more attractive. For instance, the turnover tax (discussed above) should be better targeted and registration linked to greater access to benefits like training and assistance with account-keeping, as in Mexico. In Colombia, financial and non-financial assistance to micro-enterprises has helped to increase formality (tax reforms to reduce high social security contributions were also important) (ILO, 2014; OECD, 2017b). An Online Single Submission system for licensing has been launched; it should be fully implemented and user feedback should be collected and used to make further improvements. In Colombia compliance was reinforced through more labour inspections. Raising the probability of inspection could help increase compliance in Indonesia but it should be accompanied by other policies to improve the trade-off with formalisation to avoid pushing workers into unemployment. The government hopes that the possibility of public health insurance (including for family members) will increase the attractiveness of formalising and from 2019, registration will be compulsory for self-employed workers. Promoting the benefits of insurance more widely, along with improvements in access to services, may help attract these workers. Colombia’s experience demonstrates that informality can be reduced with a persistent and multi-faceted approach.

**Box 5. Regulations, informal employment and productivity**

Simulations with a small macro-structural model (Chalaux, Kopoin and Mourougane, forthcoming) shed light on relationships between regulations and informal employment and, in turn, GDP per capita. These relationships are estimated in two steps: to informal employment and then to income. The OECD’s indicators of employment protection legislation and product market regulation allow cross-country comparisons of hypothetical reforms. The benefits in this case result from a productivity differential between the formal and informal sectors.

The simulations suggest that easing employment protection legislation to the OECD average level gradually over 10 years could shrink Indonesia’s informal sector by about 40 percentage points and raise GDP per capita by 8-32% over 10 years, depending on the assumed productivity differential between sectors (Figure 27). Indonesia would benefit more than other emerging economies due to the combination of strict employment regulation and relatively high informality. Lowering product market regulation from its 2013 level to the OECD average could lower informality by almost 25 percentage points and raise GDP per capita by another 4-16%; reforms to ease licensing procedures made since 2013 should already be contributing to growth via this channel.

The simulations are illustrative only and depend on the size of the reform, but the assumed productivity differential appears conservative: Rothenberg et al. (2016) suggest that the labour productivity of the median micro enterprise in Indonesia is only 4.5% of a large formal firm’s productivity, and the median small firm’s is 13%.
Low skills are holding back growth

Indonesia is approaching universal completion of primary school and graduation rates from lower secondary school have risen rapidly. But a relatively low share of 25-34 year-olds has completed upper secondary school or higher (Figure 28, Panel A). School-to-work transitions are weak, and there does not appear to be much reward for completing upper-secondary education, with employment rates of that group close to those with lower attainment (Panel B). And unemployment rates of medium and high-skilled 20-29 year-olds are 6 percentage points higher than for the low-skilled. One explanation is the poor quality of education (OECD, 2016a; OECD/ADB, 2015). The results of a 2016 national test led to similar conclusions to the 2015 PISA results, which indicated that around three-quarters of 15 year-olds do not have basic skills in mathematics and less than one-third have basic reading proficiency (OECD, 2016c). This contributes to informality as workers do not have the skills for higher paying formal sector jobs. Although one-fifth of government outlays is mandated to be spent on education, it is clearly not as efficient as it should be. Teachers lack necessary competencies, as well as support, and teacher absenteeism remains a problem (OECD, 2016a).
Figure 28. Educational attainment is low, and there is relatively little dispersion in employment rates

A. Educational attainment of 25-34 year-olds

B. Employment rates of 25-34 year-olds, by educational attainment

Note: Data are for 2017, or latest available year.
StatLink https://doi.org/10.1787/888933833274

Raising the quality of teaching has been challenging, despite salary increases and tightened certification requirements (OECD, 2016a). Teachers should be evaluated regularly and encouraged to undertake professional development by linking remuneration more closely to performance and ongoing training. There are advantages in using multiple evaluators; Chile uses the principal, peer evaluators (from another school), externally accredited evaluators, and a municipal evaluation commission composed of peer evaluators (OECD, 2013). School principals should also ensure performance is regularly monitored, and teachers given feedback on what they can do to improve, for example through the creation of individual teacher development plans (OECD/ADB, 2015). Building capacity to undertake appraisals is therefore also important. Better pay has made teaching more attractive; this should be used to strengthen selection into teacher training programmes so that over time retiring teachers are replaced by increasingly committed and competent teachers. Stronger school management could also raise outcomes. The expansion of the “Smart Indonesia” programme that provides financial support to poor students who stay in school aims to reduce drop-out rates. Second-chance programmes have been re-established, as previously recommended, and should be promoted so students can re-enter formal education as their circumstances change (OECD/ADB, 2015).

Following a 2016 Presidential Decree, the government is focussing on lifting the quality of vocational education and training (VET) at upper secondary school. This is linked to the government’s agenda to expand sectors such as manufacturing and tourism. Improving VET will require strong employer engagement – a critical component of successful VET systems – and co-ordination across ministries (OECD/ADB, 2015). Indeed, greater efforts are being made to engage more with industry representatives and companies. Under a new pilot programme three companies will work with 20 VET schools. As successful models for employer engagement in training and work placements are found, they should be expanded. A tax incentive for providing training is planned. New regulations opening the education sector to foreign-owned institutions could also raise the quantity and quality of supply.
An estimated 4 million additional skilled workers will be needed annually until 2030 to meet expected demand as the economy grows (Ministry of Manpower, 2017). Disincentives for investing in staff – such as fears that trained staff will leave – should be addressed via co-ordination by sectoral business groups. Training could be further encouraged through tax incentives, with appropriate monitoring. Foreign workers can fill high-priority skills gaps quickly. They transfer knowledge to local workers, contribute to a training fund and may pay higher taxes than locals. However, they are little used as regulations have been restrictive and cumbersome: at end 2017 there were 85 974 licenced foreign workers in Indonesia (BPKS Ketenagakerjaan, 2018). In 2018 the regulation relating to employing foreign workers was changed to ease the process. It is important that it be implemented effectively. The Ministry of Manpower should maintain a list of highly skilled occupations with acute shortages, as is done in several OECD countries, and ease restrictions on hiring foreign workers for these occupations accordingly.

**Improving health outcomes will reinforce learning and work**

Education and subsequent employment outcomes also depend on childhood health. Stunting is a major issue in Indonesia, affecting 30% of children in 2017 (Jahari, 2018; OECD, 2016a). Along with malnutrition, it has lasting effects on well-being by impairing cognitive function and school performance. The central government is now working with 100 districts to reduce stunting. More generally, the unified database of vulnerable households forms the basis of most programme targeting. Policy makers should continue to improve social assistance that targets the poorest households and promote breastfeeding (OECD, 2016a). At the same time, the prevalence of lifestyle-related non-communicable diseases is rising; cardiovascular and respiratory diseases, diabetes and related complications caused half of all deaths in 2014 (Fountaine et al., 2016). These disease burdens weigh on health outcomes, as well as productivity and incomes, and will add to health costs.

The ongoing expansion of public health insurance, with the aim of universal coverage by 2019, is an opportunity to boost early detection and prevention. Although the number of clinics and hospitals has expanded, long waiting times at affiliated centres and distance to medical centres remain barriers to take-up of health insurance as well as seeking early care. However, ensuring access to services will likely require extra funding, which will strain the system’s finances further, so cost containment measures will be crucial (Dartanto, 2017; OECD, forthcoming).

**Simulations of structural reforms**

Simulations using the OECD’s long-term model show that increasing average educational attainment by two years (compared to the baseline) could add 6% to GDP per capita by 2060, or almost 0.2% additional growth per year (Table 9). But the GDP gains from ensuring all current students graduate with basic skills (indicated by a PISA score of 420) would be even larger, at around 60% by 2095, or 0.6% per year (at compounded rates) (OECD, Hanushek and Woessmann, 2015). Facilitating adult education and training would increase the stock of skills faster. Through higher rates of formality this could increase incomes, and consequently tax revenues.
Table 9. Structural reforms to close gaps can yield large long-term gains

<table>
<thead>
<tr>
<th>Reform</th>
<th>Detail</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Every current student acquiring basic skills</td>
<td>Raises PISA score of current students to 420, implying Indonesia’s average PISA scores are around Thailand’s</td>
<td>0.61</td>
</tr>
<tr>
<td>Higher educational attainment</td>
<td>Raises average years of schooling of population by 2 years in addition to the increase of 2.7 years in the baseline.</td>
<td>0.22</td>
</tr>
<tr>
<td>Improved rule of law</td>
<td>Improvement in rule of law index to the OECD median country, equivalent to an increase of 1.8 point in the index</td>
<td>0.72</td>
</tr>
<tr>
<td>Narrower gender gap in employment</td>
<td>Difference in employment rates narrows by an additional 7 percentage points compared to the baseline (8 percentage points)</td>
<td>0.12</td>
</tr>
<tr>
<td>Less stringent employment protection legislation</td>
<td>The OECD Employment Protection Legislation indicator gradually declines to the OECD average</td>
<td>0.4 – 1.23</td>
</tr>
<tr>
<td>More competition-friendly product market regulation</td>
<td>The OECD Product Market Regulation indicator gradually declines to the OECD average</td>
<td>0.2 – 0.73</td>
</tr>
</tbody>
</table>

1. Estimates are based on OECD/Hanushek/Woessman (2015). These estimates are the average annual growth boost over 2015 to 2095.
2. Estimates are based on the OECD’s long-term scenarios described in Guillemette (2018).
3. Estimates are based on Chalaux, Kopoin and Mourougane (forthcoming). The range shows the estimate assuming the productivity differential between the formal and informal sector is 5% and 20%. The calculation is over 30 years.

Source: OECD calculations.

Complementing higher education with reforms that narrow gender gaps in employment rates and improve the rule of law could raise GDP growth by a further 0.8 percentage points annually. The estimated effect of reforms to labour and product markets regulations via channels typically estimated for OECD countries is modest but the effect is much larger when the effects of informality are accounted for (Table 9). Although these figures are only illustrative, they highlight the huge potential gains from bringing policy settings closer to those in OECD countries.

Using tourism to diversify the economy and support regional development

Two challenges for increasing the resilience and inclusiveness of Indonesia’s economic growth are the reliance on commodities for foreign currency earnings and the concentration of activity in Java. Java’s economy generates 55% of Indonesia’s GDP, and regional differences in income per capita are larger than in other large emerging economies (Figure 29). While it is not a silver bullet, tourism can help address both these challenges.

Tourism’s potential is high but not fully exploited

The number of visitors to Indonesia has nearly tripled over the past decade to 14 million by 2017, accelerating to average growth of nearly 14% annually in the past three years (Figure 30, Panel A). This is thanks to global growth in tourism – 4% annually – and also gains in market share following infrastructure development and more aggressive promotion. However, growth can be volatile due to the seasonal nature of tourism and because Indonesia is particularly vulnerable to natural disasters. Most visitors originate from Asia, especially from China, now the top source. Arrivals are geographically concentrated: Bali – less than 0.5% of Indonesia’s land mass – received almost half and Jakarta about a fifth (Panel B). More recently, tourism to other destinations – such as Borobudur and Lake Toba – has grown. The potential for job creation in many regions is large, as the sector is highly labour intensive. Likewise, the job mix in tourism implies that its expansion could raise the employment rate of women.
Figure 29. Regional income inequality is high in Indonesia

Note: The coefficient of variation is unweighted. The Williamson index is a similar measure of variance that weights regions by their share of the national population. Regional GDP per capita data are for 2016 for Indonesia, 2015 for Colombia and Mexico, 2014 for Brazil and 2013 for China and India.

Source: Statistics Indonesia; OECD, OECD Regional Database; OECD calculations.

StatLink https://doi.org/10.1787/888933833293

Figure 30. Indonesia is attracting more visitors

Source: CEIC; UNWTO.

StatLink https://doi.org/10.1787/888933833312

Most countries reap far higher revenues from tourism relative to GDP (Figure 31). Together with the expanding Asian middle-class, this points to an opportunity to attract more visitors, especially high-spending tourists. The Travel and Tourism Competitiveness Index highlights Indonesia’s natural and cultural resources and price competitiveness as strengths relative to regional competitors (WEF, 2017). The same index reveals large gaps in various types of infrastructure, including transport, tourist services and ICT.
Government plans foresee 20 million visitors by 2019. Tourism is prioritised in the 2015-19 medium-term development plan, which includes the development of 10 destinations – “10 new Balis”. The strategy emphasises closing infrastructure gaps and concentrates investment in four locations. Four destinations have also been designated special economic zones. To improve marketing the Ministry of Tourism’s budget was quadrupled in 2015, to 1% of total public spending (although it was cut in 2017 by 30%). This boosted the reach and quality of its promotional campaign. The Ministry also monitors social media at the destination level through a comprehensive digital tool to better target its marketing efforts.

Despite the medium-term plan and the associated tourism strategy, gaps in planning remain. Tourism affects numerous industries and depends on many public institutions, which makes co-ordination difficult. A lack of capacity is a challenge, especially in sub-national governments. Led by the central government and supported by the World Bank and Switzerland, the 10 priority destinations are gradually developing destination management plans (DMPs) – a standard management tool in this sector – but they will only be finalised in 2019, at the earliest. Effective use of DMPs can ensure that growth is inclusive by incorporating local characteristics and needs. Currently, local governments are often not involved in the planning process; indeed, special economic zones partly aim to circumvent excessively complicated local regulations.

Destination management organisations, comprising local government and private agents, are effective ways of managing transport, land use and the local effects of tourism (OECD, 2018e). Different forms are possible, to wit the independent agency for Langkawi island in Malaysia (LADA, 2018), or integration in the provincial government in the case of Bohol island in the Philippines (UNWTO and Griffith University, 2017). In Indonesia for example, there is a local authority for Lake Toba and a state-owned enterprise for Mandalika; however, they lack close relationships to local government or community representatives. The government should establish these in key destinations where they are missing, in partnership with local stakeholders, and encourage existing organisations to involve local stakeholders. Local governments also need more data to improve planning, monitoring and evaluation.
Tackling the infrastructure gap is crucial for scaling up tourism

The expansion of air transport infrastructure has facilitated the recent rapid growth of tourism. But capacity at the two main airports (in Jakarta and in Denpasar, Bali) is now fully utilised. Their quality is also weak relative to those in neighbouring countries. For example, Jakarta’s airport has a user rating of 65% compared to 80% for Bangkok and 94% for Singapore (Flightradar24, 2018). This suggests investment is needed to improve existing airports and build new ones. The government is planning to contract out the operation of some airports, which could improve their efficiency. In addition seven new airports were recently built and eight additional ones are planned by 2019, which should expand tourism to new regions. Given the government’s revenue constraints, private-sector participation should be encouraged. Cost-benefit analysis should be systematic for project selection, which is not currently the case (World Bank, 2018c). It should incorporate operation, maintenance and disposal costs as well as environmental and social impacts.

While transport is key, other infrastructure is also essential for continued growth in tourist inflows and spending. Better reach and reliability of 4G technology would enable visitors to use their smartphones more easily, including for e-payments. In addition, broadening internet availability would help local firm creation and growth and reduce the wide gap between urban and rural Internet users (72% versus 48%) (APJII, 2017). Environmental infrastructure such as waste, water, sanitation and sewerage facilities is still lacking; for example, the lack of potable tap water increases the use of plastic bottles in Jakarta.

Foreign investors can help plug some of the investment gaps that hamper tourism where the returns are sufficiently high to make projects viable. However, restrictions are significant in the transport sector, and to a lesser extent for hotels and restaurants, notably due to foreign equity limitations and restrictions on foreign personnel (Figure 32). Foreign land ownership restrictions also constrain the development of hotel and restaurants although a right to build can be issued to foreign companies for 30 years (renewable for 20 years). Easing those restrictions would facilitate private investment.

Figure 32. Restrictions on foreign direct investment across emerging market economies

FDI Regulatory Restrictiveness Index from 0 (open) to 1 (closed), 2017

Note: The FDI Regulatory Restrictiveness Index measures statutory restrictions on foreign direct investment across 22 economic sectors. It gauges the restrictiveness of a country’s FDI rules by looking at the four main types of restrictions on FDI: 1) foreign equity limitations; 2) discriminatory screening or approval mechanisms; 3) restrictions on the employment of foreigners as key personnel; and 4) other operational restrictions, e.g. on branching and on capital repatriation or on land ownership by foreign-owned enterprises.

Source: OECD, FDI Regulatory Restrictiveness Index Database.

https://doi.org/10.1787/888933833350
Given Indonesia’s highly decentralised government framework, the role of local governments in developing local opportunities should be promoted. Local initiatives are more effective in realising the potential of experience-based tourism and the creative economy (OECD, 2014). The community-led development of Banyuwangi is a successful example for other destinations (Kompas, 2016). Destinations are often missing tourist information centres that in other countries promote local businesses and provide services like Internet access. The availability of central government transfers for local governments to use for tourism-related projects is welcome: in 2018 “special allocation funds” of IDR 632 billion (USD 43 million) were allocated for 319 local government tourism-related projects, up from only 58 projects in 2016. However, as recommended in the previous Survey, monitoring of such projects should be stepped up. Allowing local governments to levy an accommodation tax on tourists would provide local areas with a direct benefit from increased tourism and provide additional funds for infrastructure that supports this sector.

**Facilitating firm creation and growth to foster local development**

The tourism sector is mostly composed of small firms. A business-friendly environment can help local populations to seize opportunities to start and grow companies. Although Indonesia’s regulatory environment has improved significantly over recent years – recognised in its Ease of Doing Business ranking – its ranking of 72nd indicates that there is still substantial scope for further improvement. Starting a business and enforcing contracts are especially difficult. An online single-submission system for licensing and permits has been launched but is not fully implemented yet.

Raising basic competencies, as discussed above, will facilitate the creation and growth of formal-sector firms. The tourism industry relies on specialised workers, such as chefs, hotel managers and tour guides, who are usually trained through vocational education and training. Several higher-education institutions specialise in tourism, but the supply of training will need to expand to meet growing needs. The government is now developing vocational higher-education institutions in more regions but should also better monitor private schools, which are the major provider of education and training in tourism. On-the-job training could be developed through more work placements. Closer and more local interaction between education institutions and employers would help in designing appropriate curricula. Colleges' focus should be flexible enough to respond to changing needs. Adult training programmes could help ensure that existing workers, including women outside the labour force, can benefit from tourism’s growth. Skills shortages are currently difficult to monitor but are evident in some areas such as in Lombok where the authorities are now establishing a new vocational higher-education institution. Forthcoming destination management plans should assess current and future skills shortages. Easing procedures for recruiting foreign workers, as currently envisaged, would help mitigate existing shortages and facilitate knowledge transfer to local personnel.

Like in other countries, the tourism sector has been an early adopter of digitalisation. The process of digitalisation, particularly relevant for tourism, can promote greater competition, create jobs and, by reducing the barrier of geographic distance, make growth more inclusive (OECD, 2017c). Digital platforms can provide opportunities for small businesses specialising in local services, such as accommodation and transportation. The Indonesia Travel X-Change, launched in 2016 to ease business-to-business connections, provides a booking and online payment system. However, it is still being developed and manages only 2,270 rooms (Nurdin, 2018). The platform should be finalised quickly and advertised more widely. Online delivery of training could help reach many people at lower cost than
traditional programmes. Online applications for filing income tax and VAT and for paying local licence fees can reduce compliance costs.

**Policies need to manage the sustainable development of tourism**

Indonesia’s exceptional natural assets are key attractions for tourists, but its environmental sustainability is lower than in regional competitors, reflecting insufficient wastewater treatment, deforestation and a large number of threatened species (WEF, 2017). The recent growth in tourists adds to pressure on infrastructure that is already insufficient, such as sanitation, waste and water-treatment facilities. This especially affects some remote regions, but also Bali (OECD, 2016a; Bali, 2015). Moreover, tourists’ consumption tends to be higher. The government’s plan is ambitious and counts on rapid growth in a limited number of destinations, which highlights the need to have the acceptance of the local population.

Shifting towards revenue-based targets, and relying less on tourist numbers, in planning would help focus on less but higher-quality tourism, and mitigate the environmental impact. Iceland’s experience highlights the importance of planning supporting infrastructure. There, tourist numbers quadrupled between 2010 and 2016, but investment failed to catch up, rapidly creating social and environmental strains (OECD, 2017d). Environmentally related infrastructure needs should be systematically incorporated in tourism planning, and infrastructure development plans should consider tourism projections. Risks of “white elephants” due to projection errors could be mitigated by designing scalable projects. Destination management plans would help identify these local needs. The creation of five sustainable tourism observatories with UNWTO can improve monitoring of the environmental impacts of tourism.

Recognising the high opportunity cost of exploiting natural resources and the economic value of tourism to these areas could reduce deforestation and preserve landscapes. Protected areas cover a relatively small share of Indonesia’s land compared to Brazil and Costa Rica, which are also rich in biodiversity (Figure 33). Eleven biosphere reserves have been created to better link preservation of biodiversity and local communities. More areas could be protected, but at the same time, a higher share could be used for sustainable tourism. User fees, combined with quantitative restrictions in highly sensitive areas, are an effective way of controlling the number of visitors to avoid over-exploitation and providing funds for maintenance and preservation (Eagles, McCool and Haynes, 2002). Raising awareness and involvement of the local population would expand what is on offer for tourists and enhance tourism’s economic benefits, thereby boosting local approval, which is also crucial for sustainability. For example, Costa Rica has successfully implemented small-scale ecotourism projects in rural zones. These projects provide revenues and employment to the local community and have helped to preserve the local environment (OECD, 2016d). Costa Rica also uses a “Social Progress Index” in tourist destinations to assess and promote sustainable social and environmental development (Stern, Wares and Epner, 2017; ITC, 2017).
Adjusting to a greener growth path

Natural-resource-based production (minerals, energy, agriculture, forestry and fishing) accounted for one-fifth of value added in 2017. Indonesia is one of 17 “mega diverse” countries rich in biodiversity, having, for example, 18% of the world’s coral reefs (CBD, 2018; UNEP-WCMC, 2014). Previous Surveys emphasised the importance of sound management of these resources to ensure sustainable growth over the long run (OECD, 2016a; 2015a). The Indonesia Biodiversity Strategy and Action Plan 2015-20 aims to improve co-ordination and set priorities to preserve Indonesia’s wealth of biodiversity. The upcoming Green Growth Policy Review of Indonesia will provide timely policy advice on managing Indonesia’s unique natural resources.

Deforestation and pollution threaten sustainability

Indonesia’s forest cover has declined at a decelerating rate in the past decade (Figure 34). However, the change during 2005-15 was the world’s largest after Brazil’s. Illegal forest and peatland fires used to clear land, notably for oil palm and timber plantations, also generate pollution and health costs. A moratorium on new concessions for plantations and logging of primary forests and peatlands has been in place since 2011 but has not been fully effective (Austin et al., 2017; Busch et al., 2015). In 2018 the President signed a three-year moratorium on new licences for oil palm plantations. More clarity over land rights and better law enforcement would help control deforestation (Table 10). The 2015 “One Map” initiative to establish a cadastre and resolve conflicting property rights is also crucial; co-operation across institutions should intensify to finalise it by 2019 as planned. Better forest management would help preserve biodiversity and also raise revenues; only one-third of potential revenues from forest use were collected over 2003-14 (KPK, 2015). Protecting
more forest areas and using satellite imagery to assist enforcement could also reduce deforestation, as in Brazil (OECD, 2018f).

**Figure 34. Deforestation in Indonesia is the second largest in the world**

Change in forest area for ten largest sources of deforestation

*Note:* The ten countries have the largest loss of forest area in million hectares.

*Source:* FAO, FAOSTAT Database.

Air pollution has increased sharply in recent years, with the year-to-year severity driven by forest and peat fires (Figure 35, Panel C). Transport, especially by road, is a major driver of the surge in NO\(_x\) and CO\(_2\) emissions, while coal-fired power generation is driving up SO\(_x\) emissions (Yudha, 2017). The number of vehicles in use almost tripled over 2005-15 (OICA, 2018). Jakarta has become the third-most congested city in the world (TomTom, 2018). Licence plate-based restrictions are in force in Jakarta, and toll roads are common. In addition to the environmentally-related tax reforms discussed above, further use of road pricing should be considered in large cities. Emissions standards for heavily polluting industries, such as coal-fired power plants, should be raised to international norms.

Marine pollution is a growing concern. Indonesia is the second-largest contributor to sea-borne plastic pollution, and its coral reefs are the most plastic-ridden in the Asia-Pacific (Lamb et al., 2018; Jambeck et al., 2015). Marine pollution is largely driven by improper disposal of municipal waste, only half of which is collected (according to the Ministry of Environment). Public education can help fight pollution, complemented by better co-ordination and capacity for waste management at local government level.
Transitioning to a low-carbon and energy-efficient economy

Growth in CO$_2$ emissions had decoupled from GDP growth during the 2000s, but that trend stopped recently (Figure 35, Panel B). The government’s objective of reducing greenhouse gas (GHG) emissions by 29% from a business-as-usual scenario by 2030 (Republic of Indonesia, 2016) is challenging because of deforestation and peat fires and rising energy consumption. The Low Carbon Development Plan launched in 2017 in preparation for the next medium-term plan focuses on using the agriculture, forestry, waste, transport and marine sectors to reduce GHG emissions. Coal accounts for over half the energy supply, and this share will undoubtedly increase. But the potential of geothermal and hydroelectricity is huge. Renewables account for 12% of electricity supply, implying that massive investment is needed to reach the targeted 23% by 2030 (IISD, 2018). Removing foreign equity restrictions in renewables generation could boost investment, as would more cost-reflective pricing. The 2017 regulation imposing locally based tariffs limits investment incentives in some regions (like Java) and should also be reviewed (Allen and Overy, 2017).

Figure 35. Some environmental indicators have deteriorated recently

A. Energy intensity

B. CO$_2$ intensity (production, demand)

C. Population exposure to fine particles

D. Other indicators

Environment-related inventions

Municipal waste generated (kg/person)

Mean annual concentration of PM$_{2.5}$ (µg/m$^3$)

% of population exposed to PM$_{2.5}$ in 2013

As discussed above, Indonesia has one of the lowest tax rates on energy among OECD and G20 countries (OECD, 2018d). Phasing out energy subsidies would help make the implicit price of emissions positive. Following that an explicit carbon tax should be introduced, initially at a low level.
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Annex. Progress in structural reform

This Annex reviews actions taken on recommendations from previous Economic Surveys that are not covered in tables within the main body of the Key Policy Insights. Recommendations that are new to this Survey are listed at the end of the Executive Summary and the relevant chapters.
### Recommendations in previous Surveys

#### A. Promoting inclusive and sustainable economic growth

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Actions taken since October 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct more public resources to improving education access and outcomes. Continue regular teacher assessments and professional development, and link teacher salaries more closely to qualifications and performance.</td>
<td>The 2019 State Budget targets 20.1 million students to be reached by the “Smart Indonesia” programme, which provides financial support to poor students who stay in school.</td>
</tr>
<tr>
<td>Raise public spending on infrastructure. Focus on transportation and logistics to support industry, as well as natural disaster prevention and water treatment.</td>
<td>The 16th economic policy package, released in July 2017, focused on reducing logistics costs. It includes the development of regional distribution centres, and aims to speed up processing of imports and exports by simplifying and reducing documentation.</td>
</tr>
<tr>
<td>Avoid protectionist measures that inhibit openness to trade and foreign investment with uncertain development payoff.</td>
<td>In 2018 the authorities relaxed foreign investment restrictions in the insurance sector and decided to allow foreign universities to open branches in Indonesia in co-operation with local private universities. The regulation relating to employing foreign workers was also changed to ease procedures.</td>
</tr>
<tr>
<td>To meet rising power needs, invest in low-carbon generating capacity, including renewables and geothermal sources.</td>
<td>In 2017 the government signed 68 power purchase agreements with private companies who will build renewable energy power plants.</td>
</tr>
<tr>
<td>Introduce a sub-minimum wage for youth directly linked to the general minimum wage.</td>
<td>No action taken.</td>
</tr>
<tr>
<td>Reduce impediments to hiring and dismissal. Reduce onerous severance payments, and ease dismissal procedures in the formal labour market. In return, introduce unemployment benefits coupled with individual unemployment savings accounts.</td>
<td>No action taken.</td>
</tr>
<tr>
<td>Improve the enforcement of intellectual property rights.</td>
<td>No action taken.</td>
</tr>
<tr>
<td>Remove formal education from the negative investment list.</td>
<td>In January 2018 the government decided to allow foreign universities to open branches in Indonesia in co-operation with local private universities.</td>
</tr>
<tr>
<td>Encourage tertiary education financing through establishing a student loan system.</td>
<td>In collaboration with the Ministry of Research, Technology and Higher Education, the state-owned bank BRI launched a student loan programme in March 2018 named &quot;Briguna Flexi Pendidikan&quot;. It is targeted at master and doctorate students who already have a fixed income.</td>
</tr>
<tr>
<td>Provide incentives for investment in skills. Create a national training fund to consolidate resources allocated to training and direct them to their most cost-efficient use.</td>
<td>No action taken.</td>
</tr>
</tbody>
</table>

#### B. Reducing poverty and inequality

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Actions taken since October 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase, and further improve targeting of, spending on poverty alleviation and health measures.</td>
<td>Conditional cash transfers continue to expand with the Family Hope Programme (PKH) granted to the 10 million poorest families by the end of 2017. The unified database of vulnerable households is being used to improve targeting.</td>
</tr>
<tr>
<td>Expand existing programmes to tackle stunting, including by encouraging breastfeeding.</td>
<td>In August 2017, the government launched the Accelerated Stunting Reduction Strategy which focuses efforts in 10 priority districts. The President committed in 2018 to reduce the stunting ratio to 28% by 2019 from 30% in 2017.</td>
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<tr>
<td>Liberalise the importation of food. Refocus National Logistics Agency (BULOG) activities on managing emergency supplies.</td>
<td>No action taken.</td>
</tr>
<tr>
<td>Increase financial inclusiveness by further developing branchless banking, drawing lessons from such countries as India, Mexico, the Philippines and Kenya.</td>
<td>As of December 2017, the Laku Pandai programme which aims to expand branchless banking covered 13.6 million customers in 27 banks compared to 3.7 million in 20 banks a year before.</td>
</tr>
<tr>
<td>Tackle labour market informality by reducing rigidities in the formal sector, and by enhancing the effectiveness of the tax-transfer system for poverty alleviation and paying other social benefits.</td>
<td>The coverage of the unified database of vulnerable households has continued to improve.</td>
</tr>
<tr>
<td>Streamline social assistance, and integrate social security payments with the income tax system. Boost funding for the most efficient measures, such as conditional cash transfers. Continue efforts to create a unified database of beneficiaries.</td>
<td>Conditional cash transfers continue to expand with the Family Hope Programme (PKH) granted to the 10 million poorest families by the end of 2017. The coverage of the unified database of vulnerable households has continued to improve.</td>
</tr>
</tbody>
</table>
### Recommendations in previous Surveys

<table>
<thead>
<tr>
<th>C. Making the most of natural resources while preserving the environment</th>
<th>Actions taken since October 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refocus the mineral ore export ban based on an evaluation of the costs and benefits of onshore processing for each mineral. Provide infrastructure and electricity to the new smelters.</td>
<td>The export ban was relaxed in January 2017 for firms that get a new mining licence. The new licences impose divestment of up to 51% and the obligation to build a smelter within five years.</td>
</tr>
<tr>
<td>Increase agricultural productivity by providing technical assistance and training, including through agreements between smallholders and large estates. Increase farmers’ access to credit by accelerating land titling.</td>
<td>In 2017 the Ministry of Agrarian Affairs and Spatial Planning had mapped 5.3 million plots of land as part of a Land Certification Programme. By June 2018 2.3 million land certificates had been issued.</td>
</tr>
</tbody>
</table>

### D. Enhancing regional development

| Work with the sub-national governments to move the regulation of business to best practice. | An online single submission system was launched in 2018; after it is fully implemented it will centralise all licensing procedures of all levels of government. |
| Experiment with different incentives in special economic zones, including more flexible labour regulation, with a view to extending proven good practices to the whole economy. | No action taken. |
| Expand assistance to help regions to improve budget planning and implementation capacity. In the interim, make greater use of special allocation funds to prioritise sub-national spending. | Performance-based budgeting has been developed in several provinces such as West Sumatra, West Java, Riau and Yogyakarta in 2017 and Gorontalo in 2018. |
| Do more to encourage sub-national governments to develop their own sources of revenue, such as by offering matching grants. Modify the transfer formula so that it does not penalise jurisdictions that exploit more fully their own fiscal capacity. | In the 2017 budget the proportion of the general allocation fund (DAU) basic allocation covering personnel costs was reduced. In the 2018 budget, the proportion of the village funds basic allocation (equal across villages) was reduced and more weight put on poor villages, the size of the area, the population and the construction cost index. |
| Make explicit villages’ service delivery responsibilities, and develop audit mechanisms to oversee their budgets. | No action taken. |